

RISK MANAGEMENT AND DISCLOSURE COMMITMENTS

In October 2000, we announced our voluntary adoption of a series of commitments designed to enhance market discipline, liquidity and capital. In September 2005, we entered into a written agreement with OFHEO that updated these commitments and set forth a process for implementing them. The letters between the company and OFHEO dated September 1, 2005 constituting the written agreement are available on the Investor Relations page of our website at www.freddiemac.com/investors/reports.html#commit. The status of our commitments at December 31, 2007 follows:

Description	Status
<p>1. <i>Periodic Issuance of Subordinated Debt:</i></p> <ul style="list-style-type: none"> • We will issue Freddie SUBS[®] securities for public secondary market trading that are rated by no fewer than two nationally recognized statistical rating organizations. • Freddie SUBS[®] securities will be issued in an amount such that the sum of total capital (core capital plus general allowance for losses) and the outstanding balance of “Qualifying subordinated debt” will equal or exceed the sum of 0.45% of outstanding PCs and Structured Securities we guaranteed and 4% of total on-balance sheet assets. Qualifying subordinated debt is discounted by one-fifth each year during the instrument’s last five years before maturity; when the remaining maturity is less than one year, the instrument is entirely excluded. We will take reasonable steps to maintain outstanding subordinated debt of sufficient size to promote liquidity and reliable market quotes on market values. • Each quarter we will submit to OFHEO calculations of the quantity of qualifying Freddie SUBS[®] securities and total capital as part of our quarterly capital report. • Every six months, we will submit to OFHEO a subordinated debt management plan that includes any issuance plans for the six months following the date of the plan. 	<ul style="list-style-type: none"> • During 2007, we did not issue any Freddie SUBS[®] securities; however, we called \$1.9 billion of higher-cost Freddie SUBS[®] securities. During 2006, we issued approximately \$3.3 billion of Freddie SUBS[®] securities, including approximately \$1.5 billion issued in exchange for previously issued Freddie SUBS[®] securities, and called approximately \$1.0 billion of Freddie SUBS[®] securities. We did not issue, call or repurchase any Freddie SUBS[®] securities during 2005. • Based upon an amended total capital plus qualifying subordinated debt report, we will report to OFHEO that at December 31, 2007 we had \$44.6 billion in total capital plus qualifying subordinated debt, resulting in a surplus of \$6.6 billion. During 2007, we submitted our quarterly total capital plus qualifying subordinated debt reports to OFHEO and we will amend these quarterly reports during the first quarter of 2008 to reflect our adjusted results. • We submitted our semi-annual subordinated debt management plans to OFHEO.
<p>2. <i>Liquidity Management and Contingency Planning:</i></p> <ul style="list-style-type: none"> • We will maintain a contingency plan providing for at least three months’ liquidity without relying upon the issuance of unsecured debt. We will also periodically test the contingency plan in consultation with OFHEO. 	<ul style="list-style-type: none"> • We have in place a liquidity contingency plan, upon which we report to OFHEO on a weekly basis. We periodically test this plan in accordance with our agreement with OFHEO.
<p>3. <i>Interest-Rate Risk Disclosures:</i></p> <ul style="list-style-type: none"> • We will provide public disclosure of our duration gap, PMVS-L and PMVS-YC interest-rate risk sensitivity results on a monthly basis. See “QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK — Interest-Rate Risk and Other Market Risks — <i>Portfolio Market Value Sensitivity and Measurement of Interest-Rate Risk</i>” for a description of these metrics. 	<ul style="list-style-type: none"> • For the year ended December 31, 2007, our duration gap averaged zero months, PMVS-L averaged \$261 million and PMVS-YC averaged \$31 million. Our 2007 monthly average duration gap, PMVS results and related disclosures are provided in our Monthly Volume Summary which is available on our website, www.freddiemac.com/investors/volsum.

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<p>4. <i>Credit Risk Disclosures:</i></p> <ul style="list-style-type: none"> We will make quarterly assessments of the impact on expected credit losses from an immediate 5% decline in single-family home prices for the entire U.S. We will disclose the impact in present value terms and measure our losses both before and after receipt of private mortgage insurance claims and other credit enhancements. 	<ul style="list-style-type: none"> Our quarterly credit risk sensitivity estimates are as follows: <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th rowspan="2"></th> <th colspan="2" style="text-align: center;">Before Receipt of Credit Enhancements ⁽¹⁾</th> <th colspan="2" style="text-align: center;">After Receipt of Credit Enhancements ⁽²⁾</th> </tr> <tr> <th style="text-align: center;">Net Present Value, or NPV⁽³⁾</th> <th style="text-align: center;">NPV Ratio⁽⁴⁾</th> <th style="text-align: center;">NPV⁽³⁾</th> <th style="text-align: center;">NPV Ratio⁽⁴⁾</th> </tr> <tr> <td></td> <td colspan="4" style="text-align: center;">(dollars in millions)</td> </tr> </thead> <tbody> <tr> <td>At:</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>12/31/07⁽⁵⁾</td> <td style="text-align: right;">\$4,036</td> <td style="text-align: right;">23.2 bps</td> <td style="text-align: right;">\$3,087</td> <td style="text-align: right;">17.8 bps</td> </tr> <tr> <td>09/30/07</td> <td style="text-align: right;">\$1,959</td> <td style="text-align: right;">11.7 bps</td> <td style="text-align: right;">\$1,415</td> <td style="text-align: right;">8.4 bps</td> </tr> <tr> <td>06/30/07</td> <td style="text-align: right;">\$1,768</td> <td style="text-align: right;">11.0 bps</td> <td style="text-align: right;">\$1,292</td> <td style="text-align: right;">8.1 bps</td> </tr> <tr> <td>03/31/07</td> <td style="text-align: right;">\$1,327</td> <td style="text-align: right;">8.6 bps</td> <td style="text-align: right;">\$ 929</td> <td style="text-align: right;">6.0 bps</td> </tr> <tr> <td>12/31/06</td> <td style="text-align: right;">\$1,128</td> <td style="text-align: right;">7.6 bps</td> <td style="text-align: right;">\$ 770</td> <td style="text-align: right;">5.2 bps</td> </tr> </tbody> </table> <p>(1) Assumes that none of the credit enhancements currently covering our mortgage loans has any mitigating impact on our credit losses.</p> <p>(2) Assumes we collect amounts due from credit enhancement providers after giving effect to certain assumptions about counterparty default rates.</p> <p>(3) Based on single-family total mortgage portfolio, excluding Structured Securities backed by Ginnie Mae Certificates.</p> <p>(4) Calculated as the ratio of NPV of the increase in credit losses to the single-family total mortgage portfolio, defined in footnote (3) above.</p> <p>(5) The significant increase in our credit risk sensitivity estimates in Q4 2007 was primarily attributable to changes in our assumptions employed to calculate the credit risk sensitivity disclosure. Given deterioration in housing fundamentals at the end of 2007, we modified our assumptions for forecasted home prices subsequent to the immediate 5% decline.</p>		Before Receipt of Credit Enhancements ⁽¹⁾		After Receipt of Credit Enhancements ⁽²⁾		Net Present Value, or NPV ⁽³⁾	NPV Ratio ⁽⁴⁾	NPV ⁽³⁾	NPV Ratio ⁽⁴⁾		(dollars in millions)				At:					12/31/07 ⁽⁵⁾	\$4,036	23.2 bps	\$3,087	17.8 bps	09/30/07	\$1,959	11.7 bps	\$1,415	8.4 bps	06/30/07	\$1,768	11.0 bps	\$1,292	8.1 bps	03/31/07	\$1,327	8.6 bps	\$ 929	6.0 bps	12/31/06	\$1,128	7.6 bps	\$ 770	5.2 bps
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<p>5. <i>Public Disclosure of Risk Rating:</i></p> <ul style="list-style-type: none"> We will seek to obtain a rating, that will be continuously monitored by at least one nationally recognized statistical rating organization, assessing “risk-to-the-government” or independent financial strength. 	<ul style="list-style-type: none"> At February 1, 2008 and December 31, 2007, our “risk-to-the-government” rating from S&P was “AA-” with a negative outlook. An S&P rating outlook assesses the potential direction of a long-term credit rating over the intermediate term (typically six months to two years). A modifier of “negative” means that a rating may be lowered. At February 1, 2008 and December 31, 2007, Moody’s “Bank Financial Strength” rating for us was “A-” and “A-” with a negative outlook, respectively. A Moody’s rating outlook is an opinion of the likely direction of a rating over the medium term. On January 9, 2008 Moody’s placed our “Bank Financial Strength” rating on review for possible downgrade, which overrode the negative outlook designation. 																																												

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders of Freddie Mac:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows, and of stockholders' equity present fairly, in all material respects, the financial position of Freddie Mac, a stockholder-owned government-sponsored enterprise and its subsidiaries (the "company") at December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We have also audited in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), the supplemental consolidated fair value balance sheets of the company as of December 31, 2007 and 2006. As described in "NOTE 16: FAIR VALUE DISCLOSURES," the supplemental consolidated fair value balance sheets have been prepared by management to present relevant financial information that is not provided by the historical-cost consolidated balance sheets and is not intended to be a presentation in conformity with accounting principles generally accepted in the United States of America. In addition, the supplemental consolidated fair value balance sheets do not purport to present the net realizable, liquidation, or market value of the company as a whole. Furthermore, amounts ultimately realized by the company from the disposal of assets or amounts required to settle obligations may vary significantly from the fair values presented. In our opinion, the supplemental consolidated fair value balance sheets referred to above present fairly, in all material respects, the information set forth therein as described in "NOTE 16: FAIR VALUE DISCLOSURES."

As discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," the company elected to offset amounts related to certain derivative contracts as of October 1, 2007, changed its method of accounting for uncertainty in income taxes as of January 1, 2007, elected to measure newly acquired interests in securitized financial assets that contain embedded derivatives at fair value as of January 1, 2007, changed its method of accounting for defined benefit plans as of December 31, 2006, changed its method for determining gains and losses on sales of certain guaranteed securities as of October 1, 2005, and changed its method of accounting for interest expense related to callable debt instruments as of January 1, 2005.

As discussed in "NOTE 20: CHANGES IN ACCOUNTING PRINCIPLES," the company changed the manner in which it accounts for the guarantee obligation as of December 31, 2007.

PricewaterhouseCoopers LLP

McLean, Virginia
February 27, 2008

FREDDIE MAC
CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	Adjusted		
	2007	2006	2005
	(dollars in millions, except share-related amounts)		
<i>Interest income</i>			
Mortgage loans	\$ 4,449	\$ 4,152	\$ 4,010
Mortgage-related securities	34,893	33,850	28,968
Cash and investments	3,568	4,262	2,606
Total interest income	<u>42,910</u>	<u>42,264</u>	<u>35,584</u>
<i>Interest expense</i>			
Short-term debt	(8,916)	(8,665)	(6,102)
Long-term debt	(29,148)	(28,218)	(23,246)
Total interest expense on debt securities	(38,064)	(36,883)	(29,348)
Due to Participation Certificate investors	(418)	(387)	(551)
Total interest expense	<u>(38,482)</u>	<u>(37,270)</u>	<u>(29,899)</u>
Expense related to derivatives	(1,329)	(1,582)	(1,058)
<i>Net interest income</i>	<u>3,099</u>	<u>3,412</u>	<u>4,627</u>
<i>Non-interest income</i>			
Management and guarantee income (includes interest on guarantee asset of \$549, \$580 and \$450, respectively)	2,635	2,393	2,076
Gains (losses) on guarantee asset	(1,484)	(978)	(1,409)
Income on guarantee obligation	1,905	1,519	1,428
Derivative gains (losses)	(1,904)	(1,173)	(1,321)
Gains (losses) on investment activity	294	(473)	(97)
Gains on debt retirement	345	466	206
Recoveries on loans impaired upon purchase	505	—	—
Foreign-currency gains (losses), net	(2,348)	96	(6)
Other income	246	236	126
<i>Non-interest income</i>	<u>194</u>	<u>2,086</u>	<u>1,003</u>
<i>Non-interest expense</i>			
Salaries and employee benefits	(896)	(830)	(805)
Professional services	(443)	(460)	(386)
Occupancy expense	(64)	(61)	(58)
Other administrative expenses	(271)	(290)	(286)
Total administrative expenses	(1,674)	(1,641)	(1,535)
Provision for credit losses	(2,854)	(296)	(307)
Real estate owned operations expense	(206)	(60)	(40)
Losses on certain credit guarantees	(1,988)	(406)	(272)
Losses on loans purchased	(1,865)	(148)	—
Low-income housing tax credit partnerships	(469)	(407)	(320)
Minority interests in earnings of consolidated subsidiaries	8	(58)	(96)
Other expenses	(222)	(200)	(530)
<i>Non-interest expense</i>	<u>(9,270)</u>	<u>(3,216)</u>	<u>(3,100)</u>
Income (loss) before income tax (expense) benefit and cumulative effect of change in accounting principle	(5,977)	2,282	2,530
Income tax (expense) benefit	2,883	45	(358)
Net income (loss) before cumulative effect of change in accounting principle	(3,094)	2,327	2,172
Cumulative effect of change in accounting principle, net of tax benefit of \$—, \$— and \$32, respectively	—	—	(59)
<i>Net income (loss)</i>	<u>\$ (3,094)</u>	<u>\$ 2,327</u>	<u>\$ 2,113</u>
Preferred stock dividends and issuance costs on redeemed preferred stock (including \$6, \$— and \$— of issuance costs on redeemed preferred stock, respectively)	(404)	(270)	(223)
Amount allocated to participating security option holders	(5)	(6)	—
<i>Net income (loss) available to common stockholders</i>	<u>\$ (3,503)</u>	<u>\$ 2,051</u>	<u>\$ 1,890</u>
Basic earnings (loss) per common share:			
Earnings (loss) before cumulative effect of change in accounting principle	\$ (5.37)	\$ 3.01	\$ 2.82
Cumulative effect of change in accounting principle, net of taxes	—	—	(0.09)
<i>Basic earnings (loss) per common share</i>	<u>\$ (5.37)</u>	<u>\$ 3.01</u>	<u>\$ 2.73</u>
Diluted earnings (loss) per common share:			
Earnings (loss) before cumulative effect of change in accounting principle	\$ (5.37)	\$ 3.00	\$ 2.81
Cumulative effect of change in accounting principle, net of taxes	—	—	(0.08)
<i>Diluted earnings (loss) per common share</i>	<u>\$ (5.37)</u>	<u>\$ 3.00</u>	<u>\$ 2.73</u>
Weighted average common shares outstanding (in thousands)			
Basic	651,881	680,856	691,582
Diluted	651,881	682,664	693,511
Dividends per common share	\$ 1.75	\$ 1.91	\$ 1.52

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

**FREDDIE MAC
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2007	Adjusted 2006
	(in millions, except share-related amounts)	
Assets		
<i>Retained portfolio</i>		
Mortgage loans:		
Held-for-investment, at amortized cost (net of allowance for loan losses of \$256 and \$69, respectively)	\$ 76,347	\$ 63,697
Held-for-sale, at lower-of-cost-or-market	3,685	1,908
Mortgage loans, net	80,032	65,605
Mortgage-related securities:		
Available-for-sale, at fair value (includes \$17,010 and \$20,463, respectively, pledged as collateral that may be repledged)	615,665	626,731
Trading, at fair value	14,089	7,597
Total mortgage-related securities	629,754	634,328
<i>Retained portfolio</i>	709,786	699,933
<i>Cash and investments</i>		
Cash and cash equivalents	8,574	11,359
Investments:		
Non-mortgage-related securities:		
Available-for-sale, at fair value	35,101	45,586
Securities purchased under agreements to resell and federal funds sold	6,562	23,028
<i>Cash and investments</i>	50,237	79,973
Accounts and other receivables, net	5,003	5,073
Derivative assets, net	827	665
Guarantee asset, at fair value	9,591	7,389
Real estate owned, net	1,736	743
Deferred tax asset	10,304	4,346
Other assets	6,884	6,788
<i>Total assets</i>	\$794,368	\$804,910
Liabilities and stockholders' equity		
<i>Debt securities, net</i>		
Senior debt:		
Due within one year	\$295,921	\$285,264
Due after one year	438,147	452,677
Subordinated debt, due after one year	4,489	6,400
<i>Total debt securities, net</i>	738,557	744,341
Due to Participation Certificate investors	—	11,123
Accrued interest payable	7,864	8,307
Guarantee obligation	13,712	9,482
Derivative liabilities, net	582	165
Reserve for guarantee losses on Participation Certificates	2,566	550
Other liabilities	4,187	3,512
<i>Total liabilities</i>	767,468	777,480
Commitments and contingencies (Notes 1, 2, 3, 12 and 13)		
Minority interests in consolidated subsidiaries	176	516
<i>Stockholders' equity</i>		
Preferred stock, at redemption value	14,109	6,109
Common stock, \$0.21 par value, 806,000,000 and 726,000,000 shares authorized, respectively, 725,863,886 shares issued and 646,266,701 and 661,254,178 shares outstanding, respectively	152	152
Additional paid-in capital	871	962
Retained earnings	26,909	31,372
Accumulated other comprehensive income (loss), or AOCI, net of taxes, related to:		
Available-for-sale securities	(7,040)	(3,332)
Cash flow hedge relationships	(4,059)	(5,032)
Defined benefit plans	(44)	(87)
Total AOCI, net of taxes	(11,143)	(8,451)
Treasury stock, at cost, 79,597,185 shares and 64,609,708 shares, respectively	(4,174)	(3,230)
<i>Total stockholders' equity</i>	26,724	26,914
<i>Total liabilities and stockholders' equity</i>	\$794,368	\$804,910

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

FREDDIE MAC
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Year Ended December 31,

	Adjusted					
	2007		2006		2005	
	Shares	Amount	Shares	Amount	Shares	Amount
			(in millions)			
<i>Preferred stock, at redemption value</i>						
Balance, beginning of year	132	\$ 6,109	92	\$ 4,609	92	\$ 4,609
Preferred stock issuances	344	8,600	40	1,500	—	—
Preferred stock redemptions	(12)	(600)	—	—	—	—
<i>Preferred stock, end of year</i>	<u>464</u>	<u>14,109</u>	<u>132</u>	<u>6,109</u>	<u>92</u>	<u>4,609</u>
<i>Common stock, par value</i>						
Balance, beginning of year	726	152	726	152	726	152
<i>Common stock, end of year</i>	<u>726</u>	<u>152</u>	<u>726</u>	<u>152</u>	<u>726</u>	<u>152</u>
<i>Additional paid-in capital</i>						
Balance, beginning of year		962		924		873
Stock-based compensation		81		60		67
Income tax benefit from stock-based compensation		—		9		6
Preferred stock issuance costs		(116)		(15)		—
Common stock issuances		(42)		(15)		(13)
Real Estate Investment Trust, or REIT, preferred stock repurchase		(14)		(1)		(9)
<i>Additional paid-in capital, end of year</i>		<u>871</u>		<u>962</u>		<u>924</u>
<i>Retained earnings</i>						
Balance, beginning of year, as previously reported						30,728
Beginning balance adjustments, net of taxes						(904)
Balance, beginning of year, as adjusted before cumulative effect of change in accounting principle						29,824
Cumulative effect of change in accounting principle, net of taxes		181		(13)		—
Balance, beginning of year, as adjusted		31,553		30,625		29,824
Net income (loss)		(3,094)		2,327		2,113
Preferred stock dividends declared		(398)		(270)		(223)
Common stock dividends declared		(1,152)		(1,310)		(1,076)
<i>Retained earnings, end of year</i>		<u>26,909</u>		<u>31,372</u>		<u>30,638</u>
<i>AOCI, net of taxes</i>						
Balance, beginning of year, as previously reported						(3,593)
Beginning balance adjustments, net of taxes						(587)
Balance, beginning of year, as adjusted before cumulative effect of change in accounting principle						(4,180)
Changes in unrealized gains (losses) related to available-for-sale securities, net of reclassification adjustments		(3,708)		(267)		(6,816)
Changes in unrealized gains (losses) related to cash flow hedge relationships, net of reclassification adjustments		973		1,254		1,637
Changes in defined benefit plans		43		(2)		7
Change in other comprehensive income, net of taxes, net of reclassification adjustments		(2,692)		985		(5,172)
Adjustment to initially apply Statement of Financial Accounting Standard, or SFAS, No. 158, net of tax		—		(84)		—
<i>AOCI, net of taxes, end of year</i>		<u>(11,143)</u>		<u>(8,451)</u>		<u>(9,352)</u>
<i>Treasury stock, at cost</i>						
Balance, beginning of year	65	(3,230)	33	(1,280)	35	(1,353)
Common stock issuances	(1)	56	(1)	50	(2)	73
Common stock repurchases	16	(1,000)	33	(2,000)	—	—
<i>Treasury stock, end of year</i>	<u>80</u>	<u>(4,174)</u>	<u>65</u>	<u>(3,230)</u>	<u>33</u>	<u>(1,280)</u>
<i>Total stockholders' equity</i>		<u>\$26,724</u>		<u>\$26,914</u>		<u>\$25,691</u>
<i>Comprehensive income (loss)</i>						
Net income (loss)		\$ (3,094)		\$ 2,327		\$ 2,113
Changes in other comprehensive income, net of taxes, net of reclassification adjustments		(2,692)		985		(5,172)
<i>Total comprehensive income (loss)</i>		<u>\$ (5,786)</u>		<u>\$ 3,312</u>		<u>\$ (3,059)</u>

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

FREDDIE MAC
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2007	Adjusted	
		2006	2005
	(in millions)		
Cash flows from operating activities			
Net income (loss)	\$ (3,094)	\$ 2,327	\$ 2,113
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Cumulative effect of change in accounting principle, net	—	—	59
Hedge accounting gains	—	(2)	(22)
Derivative losses	2,231	1,262	977
Asset related amortization — premiums, discounts and basis adjustments	(91)	128	871
Debt related amortization — premiums and discounts on certain debt securities and basis adjustments	10,894	11,176	9,149
Net discounts paid on retirements of debt	(8,405)	(7,429)	(5,206)
Gains on debt retirement	(345)	(466)	(206)
Provision for credit losses	2,854	296	311
Low-income housing tax credit partnerships	469	407	320
Losses on loans purchased	1,865	148	—
(Gains) losses on investment activity	(305)	538	267
Foreign-currency (gains) losses, net	2,348	(96)	6
Deferred income taxes	(3,943)	(1,012)	(1,462)
Purchases of held-for-sale mortgages	(21,678)	(18,352)	(26,763)
Sales of held-for-sale mortgages	19,545	18,710	23,669
Repayments of held-for-sale mortgages	138	104	118
Due to PCs and Structured Securities Trust	946	—	—
Change in trading securities	(1,922)	1,085	2,594
Change in accounts and other receivables, net	(711)	(763)	28
Change in amounts due to Participation Certificate investors, net	(10,624)	302	(3,121)
Change in accrued interest payable	(263)	718	331
Change in income taxes payable	134	(282)	607
Change in guarantee asset, at fair value	(2,203)	(1,125)	(726)
Change in guarantee obligation	4,245	1,536	1,779
Other, net	565	(473)	449
<i>Net cash provided by (used for) operating activities</i>	<u>(7,350)</u>	<u>8,737</u>	<u>6,142</u>
Cash flows from investing activities			
Purchases of available-for-sale securities	(319,213)	(386,407)	(414,062)
Proceeds from sales of available-for-sale securities	109,973	86,737	95,029
Proceeds from maturities of available-for-sale securities	219,047	305,329	249,875
Purchases of held-for-investment mortgages	(25,059)	(15,382)	(12,826)
Repayments of held-for-investment mortgages	9,177	10,466	11,893
Proceeds from mortgage insurance and sales of real estate owned	1,798	1,486	1,679
Net (increase) decrease in securities purchased under agreements to resell and Federal funds sold	16,466	(7,869)	17,038
Derivative premiums and terminations and swap collateral, net	(2,484)	910	(6,859)
Investments in low-income housing tax credit partnerships	(158)	(161)	(127)
<i>Net cash provided by (used for) investing activities</i>	<u>9,547</u>	<u>(4,891)</u>	<u>(58,360)</u>
Cash flows from financing activities			
Proceeds from issuance of short-term debt	1,016,933	750,201	857,364
Repayments of short-term debt	(986,489)	(767,427)	(854,665)
Proceeds from issuance of long-term debt	183,161	177,361	153,504
Repayments of long-term debt	(222,541)	(159,204)	(125,959)
Repayments of minority interest in consolidated subsidiaries	—	(468)	(435)
Repurchase of Real Estate Investment Trust preferred stock	(320)	(27)	(142)
Proceeds from the issuance of preferred stock	8,484	1,485	—
Redemption of preferred stock	(600)	—	—
Proceeds from issuance of common stock	14	36	59
Repurchases of common stock	(1,000)	(2,000)	—
Payment of cash dividends on preferred stock and common stock	(1,553)	(1,579)	(1,299)
Excess tax benefits associated with stock-based awards	5	14	—
Payments of low-income housing tax credit partnerships notes payable	(1,068)	(1,382)	(940)
Increase (decrease) in cash overdraft	(8)	35	(54)
<i>Net cash provided by (used for) financing activities</i>	<u>(4,982)</u>	<u>(2,955)</u>	<u>27,433</u>
Net increase (decrease) in cash and cash equivalents	(2,785)	891	(24,785)
Cash and cash equivalents at beginning of year	11,359	10,468	35,253
<i>Cash and cash equivalents at end of year</i>	<u>\$ 8,574</u>	<u>\$ 11,359</u>	<u>\$ 10,468</u>
Supplemental cash flow information			
Cash paid (received) for:			
Debt interest	\$ 37,473	\$ 33,973	\$ 27,186
Swap collateral interest	445	479	322
Derivative interest carry, net	(1,070)	325	(590)
Income taxes	927	1,250	1,212
Non-cash investing and financing activities:			
Held-for-sale mortgages securitized and retained as available-for-sale securities	169	13	175
Transfers from mortgage loans to real estate owned	3,130	1,603	1,517
Investments in low-income housing tax credit partnerships financed by notes payable	286	324	1,095
Transfers from held-for-sale mortgages to held-for-investment mortgages	41	123	291
Transfers from held-for-investment mortgages to held-for-sale mortgages	—	950	—
Transfers from retained portfolio Participation Certificates to held-for-investment mortgages	2,229	1,304	1,354

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Our financial reporting and accounting policies conform to U.S. generally accepted accounting principles, or GAAP. Effective December 31, 2007, we retrospectively applied certain changes to our accounting methods to other allowable methods considered preferable under GAAP. Our current accounting policies are described below; see “NOTE 20: CHANGES IN ACCOUNTING PRINCIPLES” for additional information. Certain amounts in prior periods have been reclassified to conform to the current presentation. We evaluate the materiality of identified errors in the financial statements using both an income statement, or “rollover,” and a balance sheet, or “iron-curtain,” approach, based on relevant quantitative and qualitative factors. Our approach is consistent with the Securities and Exchange Commission’s Staff Accounting Bulletin No. 108, “Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,” or SAB 108, which is effective for the years ended December 31, 2007 and 2006.

Estimates

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

Our estimates and judgments include, but are not limited to the following:

- estimating fair value for financial instruments (See “NOTE 16: FAIR VALUE DISCLOSURES” for a discussion of our fair value estimates);
- estimating the expected amounts of forecasted issuances of debt;
- establishing the allowance for loan losses on loans held-for-investment and the reserve for guarantee losses on PCs;
- applying the static effective yield method of amortizing our guarantee obligation into earnings based on forecasted unpaid principal balances, which requires adjustment when significant changes in economic events cause a shift in the pattern of our economic release from risk;
- applying the effective interest method, which requires estimates of the expected future amounts of prepayments of mortgage-related assets; and
- assessing when impairments should be recognized on investments in securities.

Consolidation and Equity Method of Accounting

The consolidated financial statements include our accounts and those of our subsidiaries. The equity and net earnings attributable to the minority shareholder interests in our consolidated subsidiaries are reported separately on our consolidated balance sheets as minority interests in consolidated subsidiaries and in the consolidated statements of income as minority interests in earnings of consolidated subsidiaries. All material intercompany transactions have been eliminated in consolidation.

For each entity with which we are involved, we determine whether the entity should be considered a subsidiary and thus consolidated in our financial statements. These subsidiaries include entities in which we hold more than 50% of the voting rights or over which we have the ability to exercise control. Accordingly, we consolidate our two majority-owned REITs, Home Ownership Funding Corporation and Home Ownership Funding Corporation II.

The other subsidiaries consisted of variable interest entities, or VIEs, in which we are the primary beneficiary.

A VIE is an entity (a) that has a total equity investment at risk that is not sufficient to finance its activities without additional subordinated financial support provided by any parties or (b) where the group of equity holders does not have (i) the ability to make significant decisions about the entity's activities, (ii) the obligation to absorb the entity's expected losses or (iii) the right to receive the entity's expected residual returns. We are considered the primary beneficiary of a VIE and thus consolidate the VIE when we absorb a majority of its expected losses, receive a majority of its expected residual returns (unless another enterprise receives this majority), or both. We determine if we are the primary beneficiary when we become involved in the VIE. If we are the primary beneficiary, we reconsider this decision when we sell or otherwise dispose of all or part of our variable interests to unrelated parties or if the VIE issues new variable interests to parties other than us or our related parties. Conversely, if we are not the primary beneficiary, we reconsider this decision when we acquire additional variable interests in these entities. See "NOTE 3: VARIABLE INTEREST ENTITIES" for more information. We regularly invest as a limited partner in qualified low-income housing tax credit, or LIHTC, partnerships that are eligible for federal tax credits and that mostly are VIEs. We are the primary beneficiary for certain of these LIHTC partnerships.

We use the equity method of accounting for entities over which we have the ability to exercise significant influence, but not control, such as (a) entities that are not VIEs and (b) VIEs in which we have variable interests but are not the primary beneficiary. We report our recorded investment as part of other assets on our consolidated balance sheets and recognize our share of the entity's net income or losses in the consolidated statements of income as non-interest income (loss), with an offset to the recorded investment. Our share of losses is recognized only until the recorded investment is reduced to zero, unless we have guaranteed the obligations of or otherwise committed to provide further financial support to these entities. We periodically review these investments for impairment and adjust them to fair value when a decline in market value below the recorded investment is deemed to be other-than-temporary.

In applying the equity method of accounting to the LIHTC partnerships where we are not the primary beneficiaries, our obligations to make delayed equity contributions that are unconditional and legally binding are recorded at their present value in other liabilities on the consolidated balance sheets. In addition, to the extent our recorded investment in qualified LIHTC partnerships differs from the book basis reflected at the partnership level, the difference is amortized over the life of the tax credits and included in our share of earnings (losses) from housing tax credit partnerships. Any impairment losses under the equity method for these LIHTC partnerships are included in our consolidated statements of income as part of non-interest expense — low-income housing tax credit partnerships.

Cash and Cash Equivalents and Statements of Cash Flows

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

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

Transfers of PCs and Structured Securities that Qualify as Sales

Upon completion of a transfer of a financial asset that qualifies as a sale under SFAS No. 140, "*Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, a replacement of Financial Accounting Standards Board, or FASB, Statement No. 125,*" or SFAS 140, we de-recognize all assets sold and recognize all assets obtained and liabilities incurred. Upon sale, we recognize the fair value of our obligation to guarantee the payment of principal and interest of PCs and Structured Securities transferred in sale transactions. The portion of such obligation that relates to our non-contingent obligation to stand ready to perform under our guarantee is recognized as a guarantee obligation, while the portion of the obligation that relates to estimated incurred losses on securitized assets is recognized for

consolidated balance sheet purposes as reserve for guarantee losses on PCs. The resulting gain (loss) on sale of transferred PCs and Structured Securities is reflected in our consolidated statements of income as a component of gains (losses) on investment activity.

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

Swap-Based Issuances of PCs and Structured Securities

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

We recognize the fair value of our contractual right to receive guarantee fees as a guarantee asset at the inception of an executed guarantee. Additionally, at inception of an executed guarantee, we recognize a guarantee obligation at fair value. Similar to transfers of PCs and Structured Securities that qualify as sales, that portion of our estimated guarantee liability that relates to our non-contingent obligation to stand ready to perform under a PC guarantee is recognized as guarantee obligation, while that portion of such estimated guarantee liability that relates to our contingent obligation to make payments under our guarantee is recognized on our consolidated balance sheets as reserve for guarantee losses on Participation Certificates. Credit enhancements received in connection with Guarantor Swaps and other similar exchange transactions of PCs are measured at fair value and recognized as follows: (a) pool insurance is recognized as an other asset; (b) recourse and/or indemnifications that are provided by counterparties to Guarantor Swap transactions are recognized as other assets; and (c) primary loan-level mortgage insurance is recognized at inception as a component of the recognized guarantee obligation.

Because guarantee asset, guarantee obligation and credit enhancement-related assets are valued independently of each other, net differences between these recognized assets and liabilities may exist at inception. If the amount of the guarantee asset plus the credit enhancement-related assets is greater than the total amount of the guarantee obligation, the difference between such amounts is deferred on our consolidated balance sheets as a component of guarantee obligation and referred to as deferred guarantee income. If the amount of the guarantee asset and the credit enhancement-related assets is less than the total amount of the guarantee obligation, the difference between such amounts is expensed immediately to earnings as a component of non-interest expense — losses on certain credit guarantees. Additionally, cash payments that are made or received in connection with buy-ups and buy-downs are recognized as adjustments of recognized deferred guarantee income. Likewise, credit fees that we receive at inception are also recognized as adjustments of recognized deferred guarantee income.

We account for a portion of PCs that we issue through our MultiLender Swap Program in the same manner as transfers that are accounted for as sales if we contribute collateral. The remaining portion of such PC issuances is accounted for in a manner consistent with the accounting for PCs issued through the Guarantor Swap program.

For Structured Securities that we issue to third parties in exchange for PCs and non-Freddie Mac mortgage-related securities, we generally do not recognize any incremental guarantee asset or guarantee obligation. Rather, we defer and amortize into income on a straight-line basis that portion of the transaction fee that we receive that relates to the estimated fair value of our future administrative responsibilities for issued Structured Securities. In cases where we retain portions of Structured Securities issued in such transactions, a portion of the received transaction fee is deferred as a carrying value adjustment of retained Structured Securities. The balance of transaction fees received, which relates to compensation earned

in connection with structuring-related services we rendered to third parties, is recognized immediately in earnings as other non-interest income.

Subsequent Measurement of Recognized Guarantee-Related Assets and Liabilities

Recognized Guarantee Asset

We account for a guarantee asset like a debt instrument classified as trading under SFAS No. 115, “*Accounting for Certain Investments in Debt and Equity Securities*,” or SFAS 115. Changes in the fair value of the recognized guarantee asset are reflected in earnings as a component of gains (losses) on guarantee asset. Cash collections of our contractual guarantee fee reduce the value of the guarantee asset. All guarantee-related compensation that is received over the life of the loan in cash is reflected in earnings as a component of management and guarantee income.

Recognized Guarantee Obligation

We amortize our guarantee obligation under the static effective yield method. The static effective yield will be calculated and fixed at inception of the guarantee based on forecasted unpaid principal balances. The static effective yield will be evaluated and adjusted when significant changes in economic events cause a shift in the pattern of our economic release from risk. For example, certain market environments may lead to sharp and sustained changes in home prices or prepayments of mortgages, leading to the need for an adjustment in the static effective yield for specific mortgage pools underlying the guarantee. When a change is required, a cumulative catch-up adjustment, which could be significant in a given period, will be recognized and a new static effective yield will be used to determine our guarantee obligation amortization. The resulting recorded amortization reflects our economic release from risk under changing economic scenarios. Periodic amortization of both our performance obligation and deferred income are reflected as components of the income on guarantee obligation. Separately, the subsequent measurement of our contingent obligation to make guarantee payments is further discussed below in “Allowance for Loan Losses and Reserve for Guarantee Losses.”

See “NOTE 20: CHANGES IN ACCOUNTING PRINCIPLES” for further information regarding our guarantee obligation.

Recognized Credit Enhancements

Credit enhancements that are separately recognized as other assets are amortized into earnings as other non-interest expense under the static effective yield method in the same manner as our guarantee obligation. Recurring insurance premiums are recorded at the amount paid and amortized over their contractual life and, if provided quarterly, then the amortization period is three months.

Due to Participation Certificate Investors

Beginning December 2007 we introduced separate legal entities, trusts, into our securities issuance process for the purpose of managing the receipt and payments of cash flow of our PCs and Structured Securities. In connection with the establishment of these trusts, we also established a separate custodial account in which cash remittances received on the underlying assets of our PCs and Structured Securities are deposited. These cash remittances include both scheduled and unscheduled principal and interest payments. The funds held in this account are segregated and are not commingled with our general operating funds. As securities administrator, we invest the cash held in the custodial account, pending distribution to our PC and Structured Securities holders, in short-term, risk-free investments and are entitled to trust management fees on the trust’s assets which was recorded as other non-interest income. The funds are maintained in this separate custodial account until they are due to the PC and Structured Securities holders on their respective security payment dates.

Prior to December 2007, we managed the timing differences that exist for cash receipts from servicers on assets underlying our PCs and Structured Securities and the subsequent pass through of those payments on PCs owned by third-party investors. In those cases, the PC balances were not reduced for payments of principal received from servicers in a given month until the first day of the next month and we did not release the cash received (principal and interest) to the PC investors until the fifteenth day of that next month. We generally invested the principal and interest amounts we received in short-term investments from the time the cash was received until the time we paid the PC investors. In addition, for unscheduled principal prepayments on loans underlying our PCs and Structured Securities, these timing differences resulted in expenses, since the related PCs continued to bear interest due to the PC investor at the PC coupon rate from the date of prepayment until the date the PC security balance is reduced, while no interest is received from the mortgage on that prepayment amount during that period. The expense recognized upon prepayment was reported in interest expense — due to Participation Certificate investors. We report PC coupon interest amounts relating to our investment in PCs consistent with the method used for PCs held by third party investors.

Mortgage Loans

Upon loan acquisition, we classify the loan as either held-for-sale or held-for-investment. Mortgage loans that we have the ability and intent to hold for the foreseeable future are classified as held-for-investment. Held-for-investment mortgage loans are reported at their outstanding unpaid principal balances, net of deferred fees and cost basis adjustments (including unamortized premiums and discounts). These deferred items are amortized into interest income over the estimated lives of the mortgages using the effective interest method. We use actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method. For purposes of estimating future prepayments, the mortgages are aggregated by similar characteristics such as origination date, coupon and maturity. We recognize interest on mortgage loans on an accrual basis, except when we believe the collection of principal or interest is not probable.

Mortgage loans not classified as held-for-investment are classified as held-for-sale. Held-for-sale mortgages are reported at lower-of-cost-or-market, on a portfolio basis, with gains and losses reported in gains (losses) on investment activity. Premiums and discounts on loans classified as held-for-sale are not amortized during the period that such loans are classified as held-for-sale.

Allowance for Loan Losses and Reserve for Guarantee Losses

We maintain an allowance for loan losses on mortgage loans held-for-investment and a reserve for guarantee losses on PCs, collectively referred to as our loan loss reserves, to provide for credit losses when it is probable that a loss has been incurred. The held-for-investment loan portfolio is shown net of the allowance for loan losses on the consolidated balance sheets. The reserve for guarantee losses is a liability account on our consolidated balance sheets. Increases in loan loss reserves are reflected in earnings as the provision for credit losses, while decreases are reflected through charging-off such balances (net of recoveries) when realized losses are recorded or as a reduction in the provision for credit losses. For both single-family and multifamily mortgages where the original terms of the mortgage loan agreement are modified, resulting in a concession to the borrower experiencing financial difficulties, losses are recorded at the time of modification and the loans are subsequently accounted for as troubled debt restructurings, or TDRs.

We estimate credit losses related to homogeneous pools of single-family and multifamily loans in accordance with SFAS No. 5, *“Accounting for Contingencies”* or SFAS 5. In accordance with SFAS 5, we recognize credit losses when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. We also estimate credit losses in accordance with SFAS No. 114, *“Accounting by Creditors for Impairment of a Loan”* or SFAS 114. Loans evaluated under SFAS 114, include single-family loans and multifamily loans whose contractual terms have previously been modified due to credit concerns (including TDRs), certain multifamily loans with observable collateral deficiencies or that become 60 days past due for principal and interest. In accordance with SFAS 114, we consider all available evidence, such as the present value of discounted expected future cash flows, the fair value of collateral for collateral dependent loans, and third-party credit enhancements, when establishing the loan loss reserves. Determining the adequacy of the loan loss reserves is a complex process that is subject to numerous estimates and assumptions requiring significant judgment. Loans not deemed to be impaired under SFAS 114 are grouped with other loans that share common characteristics for evaluation under SFAS 5.

Single-Family Loan Portfolio

We estimate loan loss reserves on homogeneous pools of single-family loans using statistically based models that evaluate a variety of factors. The homogeneous pools of single-family mortgage loans are determined based on common underlying characteristics, including year of origination, loan-to-value ratio and geographic region. In determining the loan loss reserves for single-family loans at the balance sheet date, we evaluate factors including, but not limited to:

- the year of loan origination;
- geographic location;
- actual and estimated amounts for loss severity trends for similar loans;
- default experience;
- expected ability to partially mitigate losses through a level of estimated successful loan modification or other alternatives to foreclosure;
- expected proceeds from credit enhancements, including primary mortgage insurance, a seller’s agreement to repurchase or replace any mortgage in default and other loss mitigation activities;

- pre-foreclosure real estate taxes and insurance; and
- estimated selling costs should the underlying property ultimately be sold.

Our credit loss reserves reflect our best estimates of incurred losses. Our reserve estimate includes projections related to strategic loss mitigation activities, including a higher rate of loan modifications for troubled borrowers, and projections of recoveries through repurchases by seller/servicers of defaulted loans due to failure to follow contractual underwriting requirements at the time of the loan origination.

Our reserve estimate also reflects our best projection of defaults we believe are likely to occur as a result of loss events that have occurred through December 31, 2007. However, the unprecedented deterioration in the national housing market and the uncertainty in other macro economic factors makes forecasting of default rates increasingly imprecise.

The inability to realize the benefits of our loss mitigation plans, a lower realized rate of seller/servicer repurchases or default rates that exceed our current projections will cause our losses to be significantly higher than those currently estimated.

We validate and update the models and factors to capture changes in actual loss experience, as well as changes in underwriting practices and in our loss mitigation strategies. We also consider macroeconomic and other factors that impact the quality of the portfolio including regional housing trends, applicable home price indices, unemployment and employment dislocation trends, consumer credit statistics and the extent of third party insurance. We determine our loan loss reserves based on our assessment of these factors.

Multifamily Loan Portfolio

We estimate loan loss reserves on the multifamily loan portfolio based on all available evidence, including but not limited to, adequacy of third-party credit enhancements, evaluation of the repayment prospects, and fair value of collateral underlying the individual loans. The review of the repayment prospects and value of collateral underlying individual loans is based on property-specific and market-level risk characteristics including apartment vacancy and rental rates.

Non-Performing Loans

Non-performing loans consist of: (a) loans whose terms have been modified due to previous delinquency or risk of delinquency (b) serious delinquencies and (c) non-accrual loans. Serious delinquencies are those single-family loans that are 90 days or more past due or in foreclosure, and multifamily loans that are more than 60 days past due or in foreclosure. Non-performing loans generally accrue interest in accordance with their contractual terms unless they are in non-accrual status. Non-accrual loans are loans where interest income is recognized on a cash basis, and includes single-family and multifamily loans 90 days or more past due.

Impaired Loans

A loan is considered impaired when it is probable to not receive all amounts due (principal and interest), in accordance with the contractual terms of the original loan agreement. Impaired loans include single-family loans, both performing and non-performing, that are troubled debt restructurings, delinquent loans purchased from PC pools whose fair value was less than acquisition cost at the date of purchase and loans subject to AICPA Statement of Position 03-3, *“Accounting for Certain Loans or Debt Securities Acquired in a Transfer”* or SOP 03-3. Multifamily impaired loans include loans whose contractual terms have previously been modified due to credit concerns (including TDRs), certain loans with observable collateral deficiencies and loans 60 days or more past due (except for certain credit-enhanced loans).

We have the option to purchase mortgage loans out of PC pools under certain circumstances, such as to resolve an existing or impending delinquency or default. Through November 2007, our general practice was to purchase the mortgage loans out of pools after the loans were 120 days delinquent. Effective December 2007, our general practice was changed to purchase loans from pools when the loans have been modified or foreclosure sales occur, or when the loans have been delinquent for 24 months, unless we determine it is economically beneficial to do so sooner. Loans that are purchased from PC pools held by third parties are recorded on our consolidated balance sheets at fair value at the date of purchase and are subsequently carried at amortized cost. We record realized losses on loans purchased when, upon purchase, the fair value is less than the unpaid principal balance, net of related reserves. Recoveries on loans impaired upon purchase represent the recapture into income of basis adjustments recorded upon purchases of delinquent loans from our PCs and Structured Securities in conjunction with our guarantee activities. These basis adjustments were previously reflected on our income statements as expenses through a combination of provision for credit losses and losses on loans purchased. Recoveries occur when a non-performing loan is repaid in full or when at the time of foreclosure the estimated fair value of the acquired property, less costs to sell, exceeds the carrying value of the loan. For impaired loans where the borrower has made required payments that return to current status, the basis adjustments are accreted into interest income over time, as periodic payments are received.

Investments in Securities

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

We record forward purchases and sales of securities that are specifically exempt from the requirements of SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” or SFAS 133, on a trade date basis. Securities underlying forward purchases and sales contracts that are not exempt from the requirements of SFAS 133 are recorded on the contractual settlement date with a corresponding commitment recorded on the trade date.

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

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

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

We review securities for potential impairment on an ongoing basis. This review considers a number of factors, including the severity of the decline in fair value, credit ratings, the length of time the investment has been in an unrealized loss position, and the likelihood of sale in the near term. While market prices and rating agency actions are factors that are considered in the impairment analysis, cash flow analysis based on default and prepayment assumptions serves as an important factor in determining if an other than temporary impairment has occurred. We recognize impairment losses when quantitative and qualitative factors indicate that it is probable that the security will suffer a contractual principal loss or interest shortfall. We also recognize impairment when qualitative factors indicate that it is likely we will not recover the unrealized loss. When evaluating these factors, we consider our intent and ability to hold the investment until a point in time at which recovery of the unrealized loss can be reasonably expected to occur. Impairment losses on manufactured housing securities exclude the effects of separate financial guarantee contracts that are not embedded in the securities because the benefits of such contracts are not recognized until claims become probable of recovery under the contracts. We resecure securities held in our retained portfolio and we typically retain the majority of the cash flows from securitization transactions in the form of Structured Securities. Certain securities in our retained portfolio have a high probability of being resecured and therefore, for those in an unrealized loss position, we may not have the intent to hold for a period of time sufficient to recover those unrealized losses. In that case, the impairment is deemed other-than-temporary. For certain securities meeting the criteria of (a) or (b) in the preceding paragraph, other than-temporary impairment is defined as occurring whenever there is an adverse change in estimated future cash flows coupled with a decline in fair value below the amortized cost basis. When a security is deemed to be other-than-temporarily impaired, the cost basis of the security is written down to fair value, with the loss recorded to gains (losses) on investment activity. Based on the new cost basis, the adjusted deferred amounts related to the impaired security are amortized over the security’s remaining life in a manner consistent with the amount and timing of the future estimated cash flows. The security cost basis is not changed for subsequent recoveries in fair value.

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

Repurchase and Resale Agreements

We enter into repurchase and resale agreements primarily as an investor or to finance our security positions. Such transactions are accounted for as purchases and sales when the transferor relinquishes control over transferred securities and as secured financings when the transferor does not relinquish control.

Debt Securities Issued

Debt securities that we issue are classified on our consolidated balance sheets as either short-term (due within one year) or long-term (due after one year), based on their remaining contractual maturity. The classification of interest expense on debt securities as either short-term or long-term is based on the original contractual maturity of the debt security. Debt securities denominated in a foreign currency are translated into U.S. dollars using foreign exchange spot rates at the balance sheet dates and any resulting gains or losses are reported in non-interest income (loss) — foreign-currency gains (losses), net.

Premiums, discounts, and hedging-related basis adjustments, are reported as a component of debt securities, net. Issuance costs are reported as a component of other assets. These items are amortized and reported through interest expense using the effective interest method over the contractual life of the related indebtedness. Amortization of premiums, discounts and issuance costs begins at the time of debt issuance. Amortization of hedging-related basis adjustments is initiated upon the termination of the related hedge relationship.

When debt securities are extinguished prior to its contractual maturity, the balances of deferred items remaining are reflected in earnings in the period of extinguishment as a component of gains (losses) on debt retirement. Contemporaneous transfers of cash between us and a creditor in connection with the issuance of a new debt obligation and satisfaction of an existing debt obligation are accounted for as either extinguishments or exchanges. If the debt instruments have substantially different terms, the transaction is accounted as an extinguishment with recognition of any gains or losses in earnings. If not, the transaction is accounted for as an exchange. In an exchange, the following are considered to be a basis adjustment on the new debt obligation and are amortized as an adjustment of interest expense over the remaining term of the new debt obligation: the fees associated with the new debt obligation and any existing unamortized premium or discount, concession fees and hedge gains and losses on the existing debt obligation.

Derivatives

We account for our derivatives pursuant to SFAS 133, as amended. Derivatives are reported at their fair value on our consolidated balance sheets. Derivatives in an asset position, including net derivative interest receivable or payable, are reported as derivative assets, net. Similarly, derivatives in a net liability position, including net derivative interest receivable or payable, are reported as derivative liabilities, net. We offset fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting agreement, in accordance with FASB Interpretation No. 39-1, “*Amendment of FASB Interpretation No. 39,*” or FSP FIN 39-1. Changes in fair value and interest accruals on derivatives are recorded as derivative gains (losses) in our consolidated statements of income.

We evaluate whether financial instruments that we purchase or issue contain embedded derivatives. In connection with the adoption of SFAS No. 155, “*Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140,*” or SFAS 155, on January 1, 2007, we elected to measure newly acquired or issued financial instruments that contain embedded derivatives at fair value, with changes in fair value recorded in our consolidated statements of income. At December 31, 2007, we do not have any embedded derivatives that are bifurcated and accounted for as freestanding derivatives.

At December 31, 2007, we did not have any derivatives in hedge accounting relationships; however, there are amounts recorded in AOCI related to terminated or de-designated cash flow hedge relationships. These deferred gains and losses on closed cash flow hedges are recognized in earnings as the originally forecasted transactions affect earnings. If it is probable the originally forecasted transaction will not occur, the associated deferred gain or loss in AOCI would be reclassified to earnings immediately. When market conditions warrant, we may enter into certain commitments to forward sell mortgage-related securities that we will account for as cash flow hedges.

During 2006 and 2005, our hedge accounting relationships primarily consisted of hedging interest-rate risk related to the forecasted issuances of debt that were designated as cash flow hedges, and fair value hedges of benchmark interest-rate risk and/or foreign currency risk on existing fixed-rate debt.

The changes in fair value of the derivatives in cash flow hedge relationships were recorded as a separate component of AOCI to the extent the hedge relationships were effective, and amounts were reclassified to earnings when the forecasted transaction affects earnings.

The changes in fair value of the derivatives in fair value relationships were recorded in earnings along with the change in the fair value of the hedged debt. Any difference was reflected as hedge ineffectiveness and was recorded in other income.

Real Estate Owned

Real estate owned, or REO, is initially recorded at fair value, net of estimated disposition costs and is subsequently carried at the lower-of-cost-or-market. When a loan is transferred to REO, losses arise when the carrying basis of the loan (including accrued interest) exceeds the fair value of the foreclosed property, net of estimated costs to sell and credit enhancements. Losses are charged-off against the allowance for loan losses at the time of transfer. REO gains arise and are recognized immediately in earnings when the fair market value of the acquired asset (after deduction for estimated disposition costs) exceeds the carrying value of the mortgage (including accrued interest). Amounts we expect to receive from third-party insurance or other credit enhancements are recorded when the asset is acquired. The receivable is adjusted when the actual claim is filed, and is a component of accounts and other receivables, net on our consolidated balance sheets. Material development and improvement costs relating to REO are capitalized. Operating expenses on the properties, net of any rental or other income, are included in REO operations income (expense). Estimated declines in REO fair value that result from ongoing valuation of the properties are provided for and charged to REO operations income (expense) when identified. Any gains and losses on REO dispositions are included in REO operations income (expense).

Income Taxes

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

We account for tax positions taken or expected to be taken (and any associated interest and penalties) in accordance with FASB Interpretation No. 48, “*Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109,*” or FIN 48. In particular, we recognize a tax position so long as it is more likely than not that it will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. We measure the tax position at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. See “NOTE 13: INCOME TAXES” for additional information related to FIN 48.

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

Stock-Based Compensation

We record compensation expense for stock-based compensation awards based on the grant-date fair value of the award and expected forfeitures. Compensation expense is recognized over the period during which an employee is required to provide service in exchange for the stock-based compensation award. The recorded compensation expense is accompanied by an adjustment to additional paid-in capital on our consolidated balance sheets. The vesting period for stock-based compensation awards is generally three to five years for options, restricted stock and restricted stock units. The vesting period for the option to purchase stock under the Employee Stock Purchase Plan, or ESPP, is three months. See “NOTE 10: STOCK-BASED COMPENSATION” for additional information.

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

Incremental compensation expense related to the modification of awards is based on a comparison of the fair value of the modified award with the fair value of the original award before modification. We generally expect to settle our stock-based compensation awards in shares. In limited cases, an award may be cash-settled upon a contingent event such as involuntary termination. These awards are accounted for as an equity award until the contingency becomes probable of occurring, when the award is reclassified from equity to a liability. We initially measure the cost of employee service received

in exchange for a stock-based compensation award of liability instruments based on the fair value of the award at the grant date. The fair value of that award is remeasured subsequently at each reporting date through the settlement date. Changes in the fair value during the service period are recognized as compensation cost over that period.

Excess tax benefits are recognized in additional paid-in capital. Cash retained as a result of the excess tax benefits is presented in the consolidated statements of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation costs reduces additional paid-in capital to the extent there are excess tax benefits from previous stock-based awards remaining in additional paid-in capital, with any remainder reported as part of income tax expense.

Earnings Per Common Share

Because we have participating securities, we use the “two-class” method of computing earnings per common share. The “two-class” method is an earnings allocation formula that determines earnings per share for common stock and participating securities based on dividends declared and participation rights in undistributed earnings. Our participating securities consist of vested options to purchase common stock and vested restricted stock units that earn dividend equivalents at the same rate when and as declared on common stock.

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

Comprehensive Income

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

Reportable Segments

We have three business segments for financial reporting purposes under SFAS No. 131, “*Disclosures about Segments of an Enterprise and Related Information*,” or SFAS 131, for all periods presented on our consolidated financial statements. See “NOTE 15: SEGMENT REPORTING” for additional information.

Recently Adopted Accounting Standards

Accounting for Employers’ Defined Benefit Pension and Other Postretirement Plans

On December 31, 2006, we adopted SFAS 158, “*Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106 and 132(R)*,” or SFAS 158. In accordance with this standard, on December 31, 2006, we recorded the funded status of each of our defined benefit pension and postretirement plans as an asset or liability on our consolidated balance sheet with a corresponding offset, net of taxes, recorded in AOCI within stockholders’ equity.

Effective December 31, 2008, SFAS 158 also requires our defined benefit plan assets and obligations to be measured as of the date of our consolidated balance sheet. We expect that the effect of implementing the change in measurement date from September 30 to December 31 will not be material to our financial condition or our results of operations.

Accounting for Uncertainty in Income Taxes

On January 1, 2007, we adopted FIN 48. FIN 48 provides a single model to account for uncertain tax positions and clarifies accounting for income taxes by prescribing a minimum threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. As a result of the adoption of FIN 48, we recorded a \$181 million increase to retained earnings at January 1, 2007. See “NOTE 13: INCOME TAXES” for additional information related to FIN 48.

Accounting for Certain Hybrid Instruments

On January 1, 2007, we adopted SFAS 155. SFAS 155 permits the fair value measurement for any hybrid financial instrument with an embedded derivative that otherwise would require bifurcation. In addition, this statement requires an evaluation of interests in securitized financial assets to identify instruments that are freestanding derivatives or that are hybrid financial instruments containing an embedded derivative requiring bifurcation. We adopted SFAS 155 prospectively,

and, therefore, there was no cumulative effect of a change in accounting principle. In connection with the adoption of SFAS 155 on January 1, 2007, we elected to measure newly acquired interests in securitized financial assets that contain embedded derivatives requiring bifurcation at fair value, with changes in fair value reflected in our consolidated statements of income. See “NOTE 4: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO” for additional information.

Offsetting of Amounts Related to Certain Contracts

On October 1, 2007, we adopted FSP FIN 39-1, which permits a reporting entity to offset fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting agreement. When offsetting of fair value amounts recognized for derivative instruments is elected, as permitted under a master netting agreement, the position requires the offsetting of amounts recognized for cash collateral held or posted when the collateral represents “fair value amounts.” Our adoption of FSP FIN 39-1 resulted in a decrease to total assets and total liabilities of \$8.7 billion.

In conjunction with our adoption of FSP FIN 39-1, we elected to reclassify net derivative interest receivable or payable and, where applicable, cash collateral held or posted on our consolidated balance sheets to derivative asset, net and derivative liability, net, as applicable. Prior to adoption these amounts were recorded in accounts and other receivables, net, accrued interest payable, other assets and senior debt: due within one year, as applicable. Certain amounts in prior periods’ consolidated balance sheets and consolidated statements of cash flows have been reclassified to conform to the current presentation. There was no impact to our consolidated statements of income.

Recently Issued Accounting Standards, Not Yet Adopted

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, “*Fair Value Measurements*,” or SFAS 157. This statement defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements but does not change existing guidance as to whether or not a financial asset or liability is carried at fair value. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 with earlier adoption permitted. We adopted SFAS 157 on January 1, 2008 and the implementation did not result in a material difference to our fair value measurements.

The Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS No. 159, “*The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115*,” or SFAS 159. This statement permits companies to choose to measure certain financial assets and liabilities at fair value with changes in fair value recognized in earnings as they occur. The objective is to improve financial reporting by providing entities with the opportunity to measure both assets and liabilities at fair value without having to apply complex hedge accounting provisions. SFAS 159 is effective as of the beginning of an entity’s first fiscal year beginning after November 15, 2007.

We adopted SFAS 159 on January 1, 2008 and elected the fair value option for certain available-for-sale mortgage-related securities that were identified as economic offsets to the changes in fair value of the guarantee asset, foreign-currency denominated debt, and investments in securities classified as available-for-sale securities and identified as within the scope of Emerging Issues Task Force Issue No. 99-20, “*Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*,” or EITF 99-20. As a result of the adoption, we recognized a \$1.0 billion after-tax increase to our beginning retained earnings at January 1, 2008, representing the effect of changing our measurement basis to fair value for the above items with the fair value option elected.

Our election of the fair value option for the items discussed above was made in an effort to better reflect, in the financial statements, the economic offsets that exist related to items that were not previously recognized as changes in fair value through the income statement.

We elected the fair value option for certain other available-for-sale securities held in the retained portfolio to better reflect the natural offset these securities provide to fair value changes recorded on the guarantee asset. We record fair value changes on our guarantee asset through the income statement. However, we historically classified virtually all of our securities as available-for-sale and recorded those fair value changes in AOCI. The securities selected for the fair value option include principal only strips and certain pass-through and Structured Securities that contain positive duration features that provide offset to the negative duration associated with our guarantee asset. We will continually evaluate new security purchases to identify the appropriate security mix to classify as trading to match the changing duration features of the guarantee asset and the securities that provide offset.

In the case of foreign currency denominated debt, we have entered into derivative transactions that effectively convert these instruments to US dollar denominated floating rate instruments. We have historically recorded the fair value changes on these derivatives through the income statement in accordance with SFAS 133. However, the corresponding offsetting change in fair value that occurred in the debt was not permitted to be recorded in the income statement unless we pursued hedge accounting. As a result, our income statement reflected only the fair value changes of the derivatives and not the offsetting fair value changes in the debt. Therefore, we have elected the fair value option on the debt instruments to better reflect the economic offset that naturally results from the debt due to changes in interest rates. We currently do not issue foreign currency denominated debt and use of the fair value option in the future for these types of instruments will be evaluated on a case-by-case basis for any new issuances of this type of debt.

For available-for-sale securities identified as in the scope of EITF 99-20, we elected the fair value option to better reflect the economic recapture of losses that occur subsequent to impairment write-downs recorded on these instruments. Under EITF 99-20 for available-for-sale securities, when an impairment is considered other-than-temporary, the impairment amount is recorded in the income statement and subsequently accreted back through interest income as long as the contractual cash flows occur. Any subsequent periodic increases in the value of the security are recognized through AOCI. By electing the fair value option for these instruments, we will reflect any recapture of impairment losses through the income statement in the period they occur. We intend to classify all future purchases of securities identified as in the scope of impairment analysis under EITF 99-20 as trading securities on a going forward basis.

Business Combinations and Noncontrolling Interests

In December 2007, the FASB issued SFAS No. 141(R), “*Business Combinations*,” or SFAS 141(R), and SFAS No. 160, “*Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*,” or SFAS 160. SFAS 141(R) provides guidance relating to recognition of assets acquired and liabilities assumed in a business combination. SFAS 160 provides guidance related to accounting for noncontrolling (minority) interests as equity in the consolidated financial statements. SFAS 141(R) and SFAS 160 are effective for fiscal years beginning on or after December 15, 2008. We have not yet determined the impact on our consolidated financial statements of adopting these accounting standards.

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

Financial Guarantees

Guaranteed PCs, Structured Securities and Other Mortgage Guarantees

As discussed in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES,” we issue two types of mortgage-related securities: PCs and Structured Securities. We guarantee the payment of principal and interest on issued PCs and Structured Securities that are backed by pools of mortgage loans, and we are obligated to purchase delinquent loans that are covered by long-term standby commitments. At December 31, 2007 and 2006, we had \$1,738.8 billion and \$1,477.0 billion, respectively, of issued PCs and Structured Securities and such other mortgage guarantees of which \$357.0 billion and \$354.3 billion were held in our retained portfolio at December 31, 2007 and 2006, respectively. There were \$1,518.8 billion and \$1,240.2 billion at December 31, 2007 and 2006, respectively, of Structured Securities backed by resecuritized PCs and other previously issued Structured Securities. These restructured securities do not increase our credit-related exposure and consist of single-class and multi-class Structured Securities backed by PCs, Real Estate Mortgage Investment Conduits, or REMICs, and principal-only strips.

Our guarantee obligation represents the recognized liability associated with our guarantee of PCs and Structured Securities net of cumulative amortization. At December 31, 2007 and 2006, our guarantee obligation includes our estimate of performance and other related costs of approximately \$9.9 billion and \$5.8 billion, respectively, and deferred guarantee income of \$3.8 billion and \$3.6 billion, respectively. In addition to our guarantee obligation, we recognized a reserve for guarantee losses on PCs that totaled \$2.6 billion and \$0.6 billion at December 31, 2007 and 2006, respectively.

Our guaranteed PCs, Structured Securities and other mortgage guarantees issued include single-family long-term stand-by commitments and multifamily housing revenue bonds issued by third parties, which totaled \$37.9 billion and \$6.7 billion at December 31, 2007 and 2006, respectively. Our guarantee of single-family long-term stand-by commitments was \$32.2 billion and \$0.7 billion at December 31, 2007 and 2006, respectively. Our guarantee of multifamily housing revenue bonds issued by third parties was \$5.7 billion and \$6.0 billion at December 31, 2007 and 2006, respectively.

Our approach for estimating the fair value of the guarantee obligation makes use of third-party market data as practicable. We divide the credit aspects of our guarantee obligation portfolio into three primary components: performing loans, non-performing loans and manufactured housing. For each component, we developed a specific valuation approach for capturing its unique characteristics.

For performing loans, we use capital markets information and rating agency models to estimate subordination levels and dealer price quotes on proxy non-agency securities with collateral characteristics matched to our portfolio to value the expected credit losses and the risk premium for unexpected losses related to our guarantee portfolio. We segmented the portfolio into distinct loan cohorts to differentiate between product types, coupon rate, seasoning, and interests retained by us versus those held by third parties.

For non-performing loans, we utilize a different method for estimating the fair value of the guarantee obligation. For loans that are extremely delinquent and have been purchased out of pools, we obtained dealer indications that reflect their non-performing status. For delinquent loans remaining in PCs, we began with the market driven performing loan and non-performing whole loan values and used empirically observed delinquency transition rates to interpolate the appropriate values in each phase of delinquency (*i.e.*, 30 days, 60 days, 90 days).

For manufactured housing, we developed an approach, subject to our judgment, for estimating the incremental credit costs associated with the manufactured housing portfolio. For approximately 0.5% of our total guarantee portfolio and 9.3% of the fair value of the guarantee obligation, we determined that there is not sufficiently reliable market data to estimate the appropriate credit costs associated with the guarantee obligation for the manufactured housing portfolio. As such, we estimated the ratio of realized credit losses for performing loans and manufactured housing loans to determine a loss history ratio. We then applied the loss history ratio to market implied performing loan guarantee obligation fair value estimates to calculate the implied credit costs for the manufactured housing portfolio. We undertook a similar process for estimating the fair value of seriously delinquent manufactured housing loans.

The components of the guarantee obligation associated with administering the collection and distribution of payments on the mortgage loans underlying a PC are estimated based upon amounts we believe other market participants would charge. Finally, we use our models to estimate the present value of net cash flows related to security program cycles. This estimate is included in the guarantee obligation valuation.

We recognize guarantee assets and guarantee obligations for PCs in conjunction with transfers accounted for as sales under SFAS 140, “*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities — a replacement of FASB Statement No. 125,*” or SFAS 125/140, as well as, beginning on January 1, 2003, transactions that do not qualify as sales, but are accounted for as guarantees pursuant to the requirements of FIN 45, “*Guarantor’s Accounting and Disclosure Requirement for Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FASB Interpretation No. 34,*” or FIN 45. At December 31, 2007 and 2006, approximately 91% and 88%, respectively, of our guaranteed PCs and Structured Securities issued had a corresponding guarantee asset or guarantee obligation recognized on our consolidated balance sheets.

Derivative Instruments

Derivative instruments include written options, written swaptions, interest-rate swap guarantees and guarantees of stated final maturity of certain of our Structured Securities. In addition, we have entered into mortgage credit agreements whereby we assume default risk for mortgage loans held by third parties for up to a 90-day period in exchange for a monthly fee.

We guarantee the performance of interest-rate swap contracts in three circumstances. First, as part of a securitization transaction, we transfer certain swaps and related assets to a third party. We guarantee that interest income generated from the assets will be sufficient to cover the required payments under the interest-rate swap contracts. Second, we guarantee that a borrower will perform under an interest-rate swap contract linked to a customer’s adjustable-rate mortgage. And third, in connection with certain Structured Securities, we guarantee that the sponsor of the securitized multifamily housing revenue bonds will perform under the interest-rate swap contract linked to the variable-rate certificates we issued, which are backed by the bonds.

In addition, we issue credit derivatives that guarantee the payments on (a) multifamily mortgage loans that are originated and held by state and municipal housing finance agencies to support tax-exempt multifamily housing revenue bonds; (b) Freddie Mac pass-through certificates which are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans; and (c) the reimbursement of certain losses incurred by third party providers of letters of credit secured by multifamily housing revenue bonds.

We issue Structured Securities with stated final maturities that are shorter than the stated maturity of the underlying mortgage loans. If the underlying mortgage loans to these securities have not been purchased by a third party or fully matured as of the stated final maturity date of such securities, we may sponsor an auction of the underlying assets. To the extent that purchase or auction proceeds are insufficient to cover unpaid principal amounts due to investors in such Structured Securities, we are obligated to fund such principal. Our maximum exposure represents the outstanding unpaid principal balance of the underlying mortgage loans.

Servicing-Related Premium Guarantees

We provide guarantees to reimburse servicers for premiums paid to acquire servicing in situations where the original seller is unable to perform under its separate servicing agreement. The liability associated with these agreements was not material at December 31, 2007 and 2006.

Table 2.1 below presents our maximum potential amount of future payments, our recognized liability and the maximum remaining term of these guarantees.

Table 2.1 — Financial Guarantees

	December 31, 2007			Adjusted December 31, 2006		
	Maximum Exposure	Recognized Liability	Maximum Remaining Term	Maximum Exposure	Recognized Liability	Maximum Remaining Term
(dollars in millions, terms in years)						
Financial Guarantees:						
Guaranteed PCs, Structured Securities and other mortgage guarantees issued ⁽¹⁾⁽²⁾	\$1,738,833	\$13,712	40	\$1,477,023	\$9,482	40
Derivative instruments	32,538	129	30	28,832	13	28
Servicing-related premium guarantees	37	—	5	44	—	5

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

(2) Effective December 2007, we established securitization trusts for the underlying assets of our PCs and Structured Securities issued. As a result, we adjusted the reported balance of our mortgage portfolios to reflect the publicly-available security balances of our PCs and Structured Securities. Previously, we reported these balances based on the unpaid principal balance of the underlying mortgage loans.

With the exception of interest-rate swap guarantees included in derivative instruments in Table 2.1, maximum exposure represents the contractual amounts that could be lost under the guarantees if underlying borrowers defaulted, without consideration of possible recoveries under recourse provisions or from collateral held or pledged. The maximum exposure related to interest-rate swap guarantees is based on contractual rates and without consideration of recovery under recourse provisions. The maximum exposure disclosed above is not representative of the actual loss we are likely to incur, based on our historical loss experience and after consideration of proceeds from related collateral liquidation.

Other Financial Commitments

As part of the guarantee arrangements pertaining to multifamily housing revenue bonds, we provided commitments to advance funds, commonly referred to as “liquidity guarantees,” totaling \$8.0 billion and \$5.8 billion at December 31, 2007 and 2006, respectively. These guarantees enable the repurchase of any tendered tax-exempt and related taxable pass-through certificates and housing revenue bonds that are unable to be remarketed. Any repurchased securities would be pledged to us to secure funding until the time when the securities could be remarketed. We have not made any payments to date under these liquidity guarantees.

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

We recognized gains (losses) on transfers of PCs and Structured Securities that were accounted for as sales under SFAS 125/140. In 2007, 2006 and 2005, these adjusted net pre-tax gains (losses) were approximately \$141 million, \$235 million and \$181 million, respectively.

Valuation of Guarantee Asset

Guarantee Asset

Our approach for estimating the fair value of the guarantee asset at December 31, 2007 uses third-party market data as practicable. For approximately 74% of the fair value of the guarantee asset, the valuation approach involved obtaining dealer quotes on proxy securities with collateral similar to aggregated characteristics of our portfolio, effectively equating the guarantee asset with current, or “spot,” market values for excess servicing interest-only, or IO, securities, which trade at a discount to trust IO security prices. We consider excess servicing securities to be comparable to the guarantee asset, in that they represent an IO-like income stream, have less liquidity than trust IO securities and do not have matching principal-only securities. The remaining 26% of the fair value of the guarantee asset related to underlying loan products for which comparable market prices were not readily available. This portion of the guarantee asset was valued using an expected cash flow approach with market input assumptions extracted from the dealer quotes provided on the more liquid products, reduced by an estimated liquidity discount.

Key Assumptions Used in the Valuation of the Guarantee Asset

Table 2.2 summarizes the key assumptions associated with the fair value measurements of the recognized guarantee asset. The fair values at the time of securitization and the subsequent fair value measurements were estimated using third-party information. However, the assumptions included in this table for those periods are those implied by our fair value

estimates, with the internal rates of return, or IRRs, adjusted where necessary to align our internal models with estimated fair values determined using third-party information. Prepayment rates are presented as implied by our internal models and have not been similarly adjusted.

At December 31, 2007 and 2006, our guarantee asset totaled \$9.6 billion and \$7.4 billion, respectively, on our consolidated balance sheets, of which approximately \$0.2 billion, or 2%, related to PCs and Structured Securities backed by multifamily mortgage loans. The key assumptions utilized in fair value measurements of the guarantee asset presented in Table 2.2 and the sensitivity analysis presented in Table 2.3 relate solely to the guarantee asset associated with PCs and other financial guarantees backed by single-family mortgage loans.

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

Mean Valuation Assumptions ⁽¹⁾	Adjusted		
	2007	2006	2005
IRRs ⁽²⁾	6.4%	8.3%	8.4%
Prepayment rates ⁽³⁾	17.1%	15.8%	17.3%
Weighted average lives (years)	5.2	5.5	5.1

(1) Mean values represent the weighted average of all IRRs, prepayment rate and weighted average lives assumptions.

(2) IRR assumptions represent an unpaid principal balance weighted average of the discount rates inherent in the fair value of the recognized guarantee asset. Weighted average lives assumptions reflect prepayment rate assumptions.

(3) Although prepayment rates are simulated monthly, the assumptions above represent annualized prepayment rates based on unpaid principal balances.

In order to report the hypothetical sensitivity of the carrying value of the guarantee asset to changes in key assumptions, we used internal models to approximate their reported carrying values. We then measured the hypothetical impact of changes in key assumptions using our models to estimate the potential view of fair value the market might have in response to those changes. In our models, the assumed internal rates of return were adjusted to calibrate our model results with the reported carrying value. However, the weighted average prepayment rate assumption used in this hypothetical sensitivity was based on our internal model which is benchmarked periodically to market prepayment estimates. The sensitivity analysis in Table 2.3 illustrates hypothetical adverse changes in the fair value of our guarantee asset for changes in key assumptions.

Table 2.3 — Sensitivity Analysis of the Guarantee Asset (Single-Family Mortgages)

	December 31,	
	2007	Adjusted 2006
	(dollars in millions)	
Fair value	\$9,417	\$7,225
Weighted average IRR assumptions:	8.1%	7.1%
Impact on fair value of 100 bps unfavorable change	\$ (389)	\$ (269)
Impact on fair value of 200 bps unfavorable change	\$ (746)	\$ (519)
Weighted average prepayment rate assumptions:	16.5%	18.4%
Impact on fair value of 10% unfavorable change	\$ (516)	\$ (368)
Impact on fair value of 20% unfavorable change	\$ (977)	\$ (695)

Valuation of Other Retained Interests

Other retained interests include securities we issued as part of a securitization transaction, which was recorded as a sale. The majority of these securities are classified as available-for-sale. The fair value of other retained interests is generally based on independent price quotations obtained from third-party pricing services or dealer provided prices.

To report the hypothetical sensitivity of the carrying value of other retained interests, we used internal models adjusted where necessary to align with the fair values. The sensitivity analysis in Table 2.4 illustrates hypothetical adverse changes in the fair value of other retained interests for changes in key assumptions based on these models.

Table 2.4 — Sensitivity Analysis of Other Retained Interests⁽¹⁾

	December 31,	
	2007	2006
	(dollars in millions)	
Fair value	\$107,931	\$127,490
Weighted average IRR assumptions:	5.5%	5.6%
Impact on fair value of 100 bps unfavorable change	\$ (4,109)	\$ (4,551)
Impact on fair value of 200 bps unfavorable change	\$ (7,928)	\$ (8,813)
Weighted average prepayment rate assumptions:	8.7%	11.0%
Impact on fair value of 10% unfavorable change	\$ (30)	\$ (66)
Impact on fair value of 20% unfavorable change	\$ (57)	\$ (132)

(1) The sensitivity analysis includes only other retained interests whose fair value is impacted as a result of changes in IRR and prepayment assumptions. At December 31, 2007 and 2006, the fair values of other retained interests not included in the sensitivity analysis above were \$44 million and \$52 million, respectively.

Cash Flows on Transfers of Securitized Interests and Corresponding Retained Interests

Table 2.5 below summarizes cash flows on retained interests as well as the amount of cash payments made to acquire delinquent loans to satisfy our financial performance obligations.

Table 2.5 — Details of Cash Flows

	Year Ended December 31,		
	2007	Adjusted	
		2006	2005
	(in millions)		
Cash flows from:			
Transfers of Freddie Mac securities that were accounted for as sales	\$62,644	\$79,565	\$93,828
Cash flows received on the guarantee asset ⁽¹⁾	2,288	1,873	1,565
Other retained interests principal and interest	22,713	24,784	25,612
Purchases of delinquent or foreclosed loans	(9,011)	(4,698)	(4,366)

(1) Represents contractual guarantee fees received by us in connection with the recognized guarantee asset.

Credit Protection and Other Forms of Recourse

In connection with our guaranteed PCs and Structured Securities issued, we have credit protection in the form of primary mortgage insurance, pool insurance, recourse to lenders and other forms of credit enhancements. Table 2.6 presents the amounts of potential loss recovery by type of credit protection.

Table 2.6 — Credit Protection and Other Forms of Recourse⁽¹⁾

	December 31,	
	2007	Adjusted
		2006
	(in millions)	
PCs and Structured Securities:		
Single-family:		
Primary mortgage insurance	\$51,897	\$40,208
Lender recourse and indemnifications	12,085	10,493
Pool insurance	3,813	3,669
Other credit enhancements	549	757
Multifamily:		
Credit enhancements	1,233	1,093
Structured Securities backed by Ginnie Mae Certificates ⁽²⁾	1,268	1,510

(1) Exclude credit enhancements related to Structured Transactions, which had unpaid principal balances that totaled \$20.2 billion and \$24.8 billion at December 31, 2007 and 2006, respectively.

(2) Ginnie Mae Certificates are backed by the full faith and credit of the U.S. government.

At December 31, 2007 and 2006, we recorded \$655 million and \$440 million, respectively, in total assets on our consolidated balance sheets related to these credit enhancements on securitized mortgages.

Indemnifications

In connection with various business transactions, we may provide indemnification to counterparties for claims arising out of breaches of certain obligations (*e.g.*, those arising from representations and warranties) in contracts entered into in the normal course of business. It is difficult to estimate our maximum exposure under these indemnification arrangements because in many cases there are no stated or notional amounts included in the indemnification clauses. Such indemnification provisions pertain to matters such as hold harmless clauses, adverse changes in tax laws, breaches of confidentiality, misconduct and potential claims from third parties related to items such as actual or alleged infringement of intellectual property. At December 31, 2007, our assessment is that the risk of any material loss from such a claim for indemnification is remote and there are no probable and estimable losses associated with these contracts. We have not recorded any liabilities related to these indemnifications on our consolidated balance sheets at December 31, 2007 and 2006.

NOTE 3: VARIABLE INTEREST ENTITIES

We are a party to numerous entities that are considered to be VIEs. Our investments in VIEs include LIHTC partnerships, certain Structured Securities transactions and a mortgage reinsurance entity. In addition, we buy the highly-rated senior securities in non-mortgage-related, asset-backed investment trusts that are VIEs. Highly-rated senior securities issued by these securitization trusts are not designed to absorb a significant portion of the variability created by the assets/collateral in the trusts. Therefore, our investments in these securities do not represent a significant variable interest in the securitization trusts. Accordingly, we do not consolidate these securities. Additionally, we invest in securitization entities that are qualifying special purpose entities, which are not subject to consolidation because of our inability to unilaterally liquidate or change the qualifying special purpose entity. See “NOTE 1: SUMMARY OF SIGNIFICANT

ACCOUNTING POLICIES — Consolidation and Equity Method of Accounting” for further information regarding the consolidation practices of our VIEs.

LIHTC Partnerships

We invest as a limited partner in LIHTC partnerships formed for the purpose of providing funding for affordable multifamily rental properties. The LIHTC partnerships invest as limited partners in lower-tier partnerships, which own and operate multifamily rental properties. These properties are rented to qualified low-income tenants, allowing the properties to be eligible for federal tax credits. Most of these LIHTC partnerships are VIEs. A general partner operates the partnership, identifying investments and obtaining debt financing as needed to finance partnership activities. Although these partnerships generate operating losses, we realize a return on our investment through reductions in income tax expense that result from tax credits and the deductibility of the operating losses of these partnerships. The partnership agreements are typically structured to meet a required 15-year period of occupancy by qualified low-income tenants. The investments in LIHTC partnerships, in which we were either the primary beneficiary or had a significant variable interest, were made between 1989 and 2007. At December 31, 2007 and 2006, we did not guarantee any obligations of these LIHTC partnerships and our exposure was limited to the amount of our investment. At December 31, 2007 and 2006, we were the primary beneficiary of investments in six partnerships and we consolidated these investments. The investors in the obligations of the consolidated LIHTC partnerships have recourse only to the assets of those VIEs and do not have recourse to us.

Consolidated VIEs

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

Table 3.1 — Assets of Consolidated VIEs

<u>Consolidated Balance Sheets Line Item</u>	<u>December 31,</u>	
	<u>2007</u>	<u>2006</u>
	(in millions)	
Cash and cash equivalents	\$ 41	\$ 44
Accounts and other receivables, net	153	173
Total assets of consolidated VIEs	<u>\$194</u>	<u>\$217</u>

VIEs Not Consolidated

LIHTC Partnerships

At December 31, 2007 and 2006, we had unconsolidated investments in 189 and 179 LIHTC partnerships, respectively, in which we had a significant variable interest. The size of these partnerships at December 31, 2007 and 2006, as measured in total assets, was \$10.3 billion and \$8.9 billion, respectively. These partnerships are accounted for using the equity method, as described in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.” As a limited partner, our maximum exposure to loss equals the undiscounted book value of our equity investment. At both December 31, 2007 and 2006, our maximum exposure to loss on unconsolidated LIHTC partnerships, in which we had a significant variable interest, was \$3.7 billion.

Asset-Backed Investment Trusts

We invest in a variety of non-mortgage-related, asset-backed investment trusts. These investments represent interests in trusts consisting of a pool of receivables or other financial assets, typically credit card receivables, auto loans or student loans. These trusts act as vehicles to allow originators to securitize assets. Securities are structured from the underlying pool of assets to provide for varying degrees of risk. Primary risks include potential loss from the credit risk and interest-rate risk of the underlying pool. The originators of the financial assets or the underwriters of the deal create the trusts and typically own the residual interest in the trust assets. At December 31, 2007 and 2006, we did not have a significant variable interest in and were not the primary beneficiary of any asset-backed investment trusts.

Structured Transactions

We periodically issue securities in Structured Transactions, which are backed by mortgage loans or non-Freddie Mac mortgage-related securities using collateral pools transferred to a trust specifically created for the purpose of issuing securities. These trusts also issue various senior interests and subordinated interests. We purchase interests, including senior interests, of the trusts and issue and guarantee Structured Securities backed by these interests. The subordinated interests are generally either held by the seller or other party or sold in the capital markets. Generally, the structure of the transactions and the trusts as qualifying special purpose entities exempts them from the scope of FASB Interpretation No. 46 (revised December 2003), “*Consolidation of Variable Interest Entities, an interpretation of ARB No. 51,*” or FIN 46(R). However, at December 31, 2007 and 2006, we had interests in one and two Structured Transactions, respectively, that did not fall within this scope exception and in which we had a significant variable interest. Our involvement in this one Structured

Transaction at December 31, 2007 began in 2002. The sizes of the one Structured Transaction at December 31, 2007 and the two Structured Transactions at December 31, 2006, as measured in total assets, were \$40 million and \$67 million, respectively. At December 31, 2007 and 2006, our maximum exposure to loss on these transactions was \$37 million and \$55 million, respectively, consisting of the book value of our investments plus incremental guarantees of the senior interests that are held by third parties. At December 31, 2007 and 2006, we were not the primary beneficiary of any such transactions.

NOTE 4: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO

Table 4.1 summarizes amortized cost, estimated fair values and corresponding gross unrealized gains and gross unrealized losses for available-for-sale securities by major security type.

Table 4.1 — Available-For-Sale Securities

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	(in millions)			
<u>December 31, 2007</u>				
<i>Retained portfolio:</i>				
Mortgage-related securities issued by:				
Freddie Mac	\$346,569	\$2,981	\$ (2,583)	\$346,967
Federal National Mortgage Association, or Fannie Mae	45,688	513	(344)	45,857
Ginnie Mae	545	19	(2)	562
Other	218,848	673	(11,820)	207,701
Obligations of states and political subdivisions	14,783	146	(351)	14,578
Total mortgage-related securities	<u>626,433</u>	<u>4,332</u>	<u>(15,100)</u>	<u>615,665</u>
<i>Cash and investments portfolio:</i>				
Non-mortgage-related securities:				
Asset-backed securities	16,644	25	(81)	16,588
Commercial paper	18,513	—	—	18,513
Total non-mortgage-related securities	<u>35,157</u>	<u>25</u>	<u>(81)</u>	<u>35,101</u>
Total available-for-sale securities	<u>\$661,590</u>	<u>\$4,357</u>	<u>\$(15,181)</u>	<u>\$650,766</u>
<u>Adjusted</u>				
<u>December 31, 2006</u>				
<i>Retained portfolio:</i>				
Mortgage-related securities issued by:				
Freddie Mac	\$348,591	\$1,438	\$ (5,941)	\$344,088
Fannie Mae	44,223	323	(660)	43,886
Ginnie Mae	720	17	(4)	733
Other	224,642	553	(1,096)	224,099
Obligations of states and political subdivisions	13,622	334	(31)	13,925
Total mortgage-related securities	<u>631,798</u>	<u>2,665</u>	<u>(7,732)</u>	<u>626,731</u>
<i>Cash and investments portfolio:</i>				
Non-mortgage-related securities:				
Asset-backed securities	32,179	23	(80)	32,122
Commercial paper	11,191	—	—	11,191
Obligations of states and political subdivisions	2,273	—	—	2,273
Total non-mortgage-related securities	<u>45,643</u>	<u>23</u>	<u>(80)</u>	<u>45,586</u>
Total available-for-sale securities	<u>\$677,441</u>	<u>\$2,688</u>	<u>\$(7,812)</u>	<u>\$672,317</u>

Table 4.2 shows the fair value of available-for-sale securities in a gross unrealized loss position and whether they have been in that position less than 12 months or 12 months or greater.

Table 4.2 — Available-For-Sale Securities in a Gross Unrealized Loss Position

	Less than 12 months		12 months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2007						
<i>Retained portfolio:</i>						
Mortgage-related securities issued by:						
Freddie Mac	\$ 22,546	\$ (254)	\$135,966	\$ (2,329)	\$158,512	\$ (2,583)
Fannie Mae	4,728	(17)	15,214	(327)	19,942	(344)
Ginnie Mae	2	—	74	(2)	76	(2)
Other	129,600	(10,215)	45,969	(1,605)	175,569	(11,820)
Obligations of states and political subdivisions	7,735	(264)	1,286	(87)	9,021	(351)
Total mortgage-related securities	<u>164,611</u>	<u>(10,750)</u>	<u>198,509</u>	<u>(4,350)</u>	<u>363,120</u>	<u>(15,100)</u>
<i>Cash and investments portfolio:</i>						
Non-mortgage-related securities:						
Asset-backed securities	8,236	(63)	3,222	(18)	11,458	(81)
Total non-mortgage-related securities	<u>8,236</u>	<u>(63)</u>	<u>3,222</u>	<u>(18)</u>	<u>11,458</u>	<u>(81)</u>
Total available-for-sale securities in a gross unrealized loss position	<u>\$172,847</u>	<u>\$(10,813)</u>	<u>\$201,731</u>	<u>\$(4,368)</u>	<u>\$374,578</u>	<u>\$(15,181)</u>
Adjusted						
December 31, 2006						
<i>Retained portfolio:</i>						
Mortgage-related securities issued by:						
Freddie Mac	\$41,249	\$(290)	\$204,715	\$(5,651)	\$245,964	\$(5,941)
Fannie Mae	5,604	(69)	22,567	(591)	28,171	(660)
Ginnie Mae	146	—	99	(4)	245	(4)
Other	35,228	(110)	36,072	(986)	71,300	(1,096)
Obligations of states and political subdivisions	959	(7)	1,245	(24)	2,204	(31)
Total mortgage-related securities	<u>83,186</u>	<u>(476)</u>	<u>264,698</u>	<u>(7,256)</u>	<u>347,884</u>	<u>(7,732)</u>
<i>Cash and investments portfolio:</i>						
Non-mortgage-related securities:						
Asset-backed securities	6,402	(7)	9,141	(73)	15,543	(80)
Total non-mortgage-related securities	<u>6,402</u>	<u>(7)</u>	<u>9,141</u>	<u>(73)</u>	<u>15,543</u>	<u>(80)</u>
Total available-for-sale securities in a gross unrealized loss position	<u>\$89,588</u>	<u>\$(483)</u>	<u>\$273,839</u>	<u>\$(7,329)</u>	<u>\$363,427</u>	<u>\$(7,812)</u>

At December 31, 2007, gross unrealized losses on available-for-sale securities were \$15.2 billion, or approximately 4% of the fair value of such securities in an unrealized loss position, as noted in Table 4.2. The gross unrealized losses relate to approximately 69 thousand individual lots representing approximately 15 thousand separate securities. We routinely purchase multiple lots of individual securities at different times and at different costs. We determine gross unrealized gains and gross unrealized losses by specifically identifying investment positions at the lot level; therefore, some of the lots we hold for a single security may be in an unrealized gain position while other lots for that security are in an unrealized loss position, depending upon the amortized cost of the specific lot.

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

- **Freddie Mac securities.** The unrealized losses on our securities are primarily a result of movements in interest rates. Because we guarantee the payment of principal and interest on these securities, we review the estimated credit exposure of the mortgages underlying these securities in evaluating potential impairment. The extent and duration of the decline in fair value relative to the amortized cost have met our criteria for determining that the impairment of these securities is temporary.
- **Fannie Mae securities and obligations of states and political subdivisions.** The unrealized losses on Fannie Mae securities and obligations of states and political subdivisions are primarily a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost have met our criteria for determining that the impairment of these securities is temporary and no other facts or circumstances existed to suggest that the

decline was not temporary. The issuer guarantees related to these securities have led us to conclude that any credit risk is minimal.

- **Other securities in the retained portfolio and asset-backed securities in the cash and investments portfolio.** The unrealized losses on mortgage-related securities included in other and asset-backed securities are principally a result of decreased liquidity and larger risk premiums in the subprime market. Our review of these securities included cash flow analyses based on default and prepayment assumptions that indicate that the impairment of these securities is temporary. Most of these securities are investment grade (*i.e.*, rated BBB– or better on a Standard and Poor’s, or S&P, or equivalent scale).

For the years ended December 31, 2007, 2006 and 2005, we recorded impairments related to investments in securities of \$399 million, \$404 million and \$292 million, respectively.

Table 4.3 below illustrates the gross realized gains and gross realized losses received from the sale of available-for-sale securities.

Table 4.3 — Gross Realized Gains and Gross Realized Losses on Available-For-Sale Securities

	Year Ended December 31,		
	2007	Adjusted	
		(in millions)	
		2006	2005
Gross realized gains	\$688	\$ 376	\$762
Gross realized (losses)	(456)	(516)	(392)
Net realized gains (losses)	<u>\$232</u>	<u>\$ (140)</u>	<u>\$370</u>

Table 4.4 summarizes, by major security type, the remaining contractual maturities and weighted average yield of available-for-sale securities.

Table 4.4 — Maturities and Weighted Average Yield of Available-For-Sale Securities

<u>December 31, 2007</u>	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Weighted Average Yield⁽¹⁾</u>
	(dollars in millions)		
<i>Retained portfolio:</i>			
Total mortgage-related securities ⁽²⁾			
Due 1 year or less	\$ 550	\$ 548	4.12%
Due after 1 through 5 years	1,776	1,810	5.77
Due after 5 through 10 years	25,486	25,659	5.32
Due after 10 years	598,621	587,648	5.39
Total	<u>\$626,433</u>	<u>\$615,665</u>	5.38
<i>Cash and investments portfolio:</i>			
Non-mortgage-related securities:			
Asset-backed securities ⁽²⁾			
Due 1 year or less	\$ —	\$ —	—
Due after 1 through 5 years	11,327	11,302	4.99
Due after 5 through 10 years	4,665	4,640	5.04
Due after 10 years	652	646	4.98
Total	<u>16,644</u>	<u>16,588</u>	5.00
Commercial paper			
Due 1 year or less	18,513	18,513	5.93
Due after 1 through 5 years	—	—	—
Due after 5 through 10 years	—	—	—
Due after 10 years	—	—	—
Total	<u>18,513</u>	<u>18,513</u>	5.93
Total non-mortgage-related securities			
Due 1 year or less	18,513	18,513	5.93
Due after 1 through 5 years	11,327	11,302	4.99
Due after 5 through 10 years	4,665	4,640	5.04
Due after 10 years	652	646	4.98
Total	<u>\$ 35,157</u>	<u>\$ 35,101</u>	5.49
<i>Total available-for-sale securities for retained portfolio and cash and investments portfolio:</i>			
Due 1 year or less	\$ 19,063	\$ 19,061	5.88
Due after 1 through 5 years	13,103	13,112	5.10
Due after 5 through 10 years	30,151	30,299	5.28
Due after 10 years	599,273	588,294	5.38
Total	<u>\$661,590</u>	<u>\$650,766</u>	5.39

(1) The weighted average yield is calculated based on a yield for each individual lot held at December 31, 2007. The numerator for the individual lot yield consists of the sum of (a) the year-end interest coupon rate multiplied by the year-end unpaid principal balance and (b) the annualized amortization income or expense calculated for December 2007 (excluding any adjustments recorded for changes in the effective rate). The denominator for the individual lot yield consists of the year-end amortized cost of the lot excluding effects of other-than-temporary impairments on the unpaid principal balances of impaired lots.

(2) Maturity information provided is based on contractual maturities, which may not represent expected life, as obligations underlying these securities may be prepaid at any time without penalty.

Table 4.5 presents the changes in AOCI, net of taxes, related to available-for-sale securities. The net unrealized holding losses, net of tax, represents the net fair value adjustments recorded on available-for-sale securities throughout the year, after the effects of our federal statutory tax rate of 35%. The net reclassification adjustment for net realized losses (gains), net of tax, represents the amount of those fair value adjustments, after the effects of our federal statutory tax rate of 35%, that have been recognized in earnings due to a sale of an available-for-sale security or the recognition of an impairment loss. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for further information regarding the component of AOCI related to available-for-sale securities.

Table 4.5 — AOCI, Net of Taxes, Related to Available-For-Sale Securities

	Year Ended December 31,		
	2007	Adjusted	
		2006	2005
		(in millions)	
Beginning balance	\$ (3,332)	\$ (3,065)	\$ 3,751
Net unrealized holding losses, net of tax ⁽¹⁾	(3,792)	(551)	(6,755)
Net reclassification adjustment for net realized losses (gains), net of tax ⁽²⁾⁽³⁾	84	284	(61)
Ending balance	<u>\$ (7,040)</u>	<u>\$ (3,332)</u>	<u>\$ (3,065)</u>

- (1) Net of tax benefit of \$2.0 billion, \$0.3 billion and \$3.6 billion for the years ended December 31, 2007, 2006 and 2005, respectively.
(2) Net of tax benefit (expense) of \$45 million, \$153 million and \$(33) million for the years ended December 31, 2007, 2006 and 2005, respectively.
(3) Includes the reversal of previously recorded unrealized losses that have been recognized on our consolidated statements of income as impairment losses on available-for-sale securities of \$234 million, \$193 million and \$180 million, net of taxes, for the years ended December 31, 2007, 2006 and 2005, respectively.

Table 4.6 summarizes the estimated fair values by major security type for trading securities held in our retained portfolio.

Table 4.6 — Trading Securities in our Retained Portfolio

	December 31,	
	2007	2006
	(in millions)	
Mortgage-related securities issued by:		
Freddie Mac	\$12,216	\$6,573
Fannie Mae	1,697	802
Ginnie Mae	175	222
Other	1	—
Total trading securities in our retained portfolio	<u>\$14,089</u>	<u>\$7,597</u>

For the years ended December 31, 2007, 2006 and 2005 we recorded net unrealized gains (losses) on trading securities held at December 31, 2007, 2006 and 2005 of \$539 million, \$(7) million and \$(278) million, respectively.

Total trading securities in our retained portfolio include \$4.2 billion of SFAS 155 related assets as of December 31, 2007. Gains (losses) on trading securities on our consolidated statements of income include gains of \$324 million related to these SFAS 155 trading securities for the year ended December 31, 2007.

Retained Portfolio Voluntary Growth Limit

We are currently operating under a voluntary, temporary limit on the growth of our retained portfolio that we instituted in response to a request by the Office of Federal Housing Enterprise Oversight, or OFHEO. Under this voluntary, temporary growth limit, the growth of our retained portfolio is limited to 2.0% annually. On September 19, 2007, OFHEO provided an interpretation regarding the calculation methodology of the voluntary, temporary growth limit. The interpretation changed the methodology for measuring the growth limit of our retained portfolio to be based on an unpaid principal balance measurement from a GAAP measurement. Compliance with the growth limit will not take into account any net increase in delinquent loan balances in the retained portfolio after September 30, 2007.

The average unpaid principal balance for the six months ended December 31, 2007, calculated using cumulative average month-end portfolio balances, was \$26.9 billion below our voluntary growth limit of \$742.4 billion.

Collateral Pledged

Collateral Pledged to Freddie Mac

Our counterparties are required to pledge collateral for reverse repurchase transactions and most interest-rate swap transactions subject to collateral posting thresholds generally related to a counterparty’s credit rating. Although it is our practice not to repledge assets held as collateral, a portion of the collateral may be repledged based on master agreements related to our interest-rate swap transactions. At December 31, 2007 and 2006, we did not have collateral in the form of securities pledged to and held by us under interest-rate swap agreements.

Collateral Pledged by Freddie Mac

We are also required to pledge collateral for margin requirements with third-party custodians in connection with secured financings, interest-rate swap agreements, futures and daily trade activities with some counterparties. The level of collateral pledged related to our interest-rate swap agreements is determined after giving consideration to our credit rating. As of December 31, 2007, we had two uncommitted intraday lines of credit with third parties, both of which are secured. In certain limited circumstances, the lines of credit agreements give the secured parties the right to repledge the securities underlying our financing to other third parties, including the Federal Reserve Bank.

Table 4.7 summarizes all securities pledged as collateral by us, including assets that the secured party may repledge and those that may not be repledged.

Table 4.7 — Collateral in the Form of Securities Pledged

	December 31,	
	2007	2006
(in millions)		
Securities pledged with ability for secured party to repledge		
Available-for-sale	\$17,010	\$20,463
Securities pledged without ability for secured party to repledge		
Available-for-sale	793	225
Total securities pledged	<u>\$17,803</u>	<u>\$20,688</u>

NOTE 5: MORTGAGE LOANS AND LOAN LOSS RESERVES

We own both single-family mortgage loans, which are secured by one to four family residential properties, and multifamily mortgage loans, which are secured by properties with five or more residential rental units.

The following table summarizes the types of loans within our retained mortgage loan portfolio as of December 31, 2007 and 2006. These balances do not include mortgage loans underlying our guaranteed PCs and Structured Securities, since these are not consolidated on our balance sheets. See “NOTE 2: FINANCIAL GUARANTEES AND TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” for information on our securitized mortgage loans.

Table 5.1 — Mortgage Loans within the Retained Portfolio

	December 31,	
	2007	2006
(in millions)		
Single-family ⁽¹⁾ :		
Conventional		
Fixed-rate	\$20,707	\$18,427
Adjustable-rate	2,700	1,233
Total conventional	23,407	19,660
FHA/VA — Fixed-rate	311	196
Rural Housing Service and other federally guaranteed loans	871	784
Total single-family	<u>24,589</u>	<u>20,640</u>
Multifamily ⁽¹⁾ :		
Conventional		
Fixed-rate	53,111	41,863
Adjustable-rate	4,455	3,341
Total conventional	57,566	45,204
Rural Housing Service	3	3
Total multifamily	<u>57,569</u>	<u>45,207</u>
Total unpaid principal balance of mortgage loans	82,158	65,847
Deferred fees, unamortized premiums, discounts and other cost basis adjustments	(1,868)	(171)
Lower of cost or market adjustments on loans held-for-sale	(2)	(2)
Allowance for loan losses on loans held-for-investment	(256)	(69)
Total mortgage loans, net of allowance for loan losses	<u>\$80,032</u>	<u>\$65,605</u>

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

For the years ended December 31, 2007 and 2006, we transferred \$41 million and \$123 million, respectively, of held-for-sale mortgage loans to held-for-investment. For the years ended December 31, 2007 and 2006, we transferred \$— and \$950, respectively, of held-for-investment mortgage loans to held-for-sale.

Loan Loss Reserves

We maintain an allowance for loan losses on mortgage loans that we classify as held-for-investment and a reserve for guarantee losses for mortgage loans that underlie guaranteed PCs and Structured Securities, collectively referred to as loan loss reserves. Loan loss reserves are established to provide for credit losses when it is probable that a loss has been incurred.

Table 5.2 summarizes loan loss reserve activity:

Table 5.2 — Detail of Loan Loss Reserves

	Year Ended December 31,								
	2007			2006 (Adjusted)			2005 (Adjusted)		
	Reserves related to:			Reserves related to:			Reserves related to:		
Retained Mortgages	PCs and Structured Securities	Total Loan Loss Reserves	Retained Mortgages	PCs and Structured Securities	Total Loan Loss Reserves	Retained Mortgages	PCs and Structured Securities	Total Loan Loss Reserves	
(in millions)									
Beginning balance	\$ 69	\$ 550	\$ 619	\$ 118	\$ 430	\$ 548	\$ 115	\$ 240	\$ 355
Provision for credit losses	321	2,533	2,854	98	198	296	112	195	307
Charge-offs ⁽¹⁾⁽²⁾	(373)	(3)	(376)	(313)	—	(313)	(294)	—	(294)
Recoveries ⁽¹⁾	239	—	239	166	—	166	185	—	185
Transfers, net ⁽³⁾	—	(514)	(514)	—	(78)	(78)	—	(5)	(5)
Ending balance	<u>\$ 256</u>	<u>\$ 2,566</u>	<u>\$ 2,822</u>	<u>\$ 69</u>	<u>\$ 550</u>	<u>\$ 619</u>	<u>\$ 118</u>	<u>\$ 430</u>	<u>\$ 548</u>

- (1) Charge-offs or recoveries are presented in the retained mortgages columns above when credit losses related to off-balance sheet PCs have been preceded by the purchase of a delinquent mortgage loan from the PC pool.
- (2) Charge-offs related to retained mortgages represent the amount of the unpaid principal balance of a loan that has been discharged using the reserve balance to remove the loan from our retained portfolio at the time of resolution. Charge-offs exclude \$156 million in 2007 related to reserve amounts previously transferred to reduce the carrying value of loans purchased under financial guarantees.
- (3) Consist of: (a) the transfer of reserves associated with non-performing loans purchased from mortgage pools underlying our PCs, Structured Securities and long-term standby agreements to establish the initial recorded investment in these loans at the date of our purchase; (b) amounts attributable to uncollectible interest on PCs and Structured Securities in our retained portfolio; and (c) other transfers, net.

Impaired Loans

Single-family impaired loans include performing and non-performing troubled debt restructurings, as well as delinquent loans that were purchased from mortgage pools underlying our PCs and Structured Securities and long-term standby agreements. Multifamily impaired loans include loans whose contractual terms have previously been modified due to credit concerns (including TDRs), certain loans with observable collateral deficiencies, loans impaired based on management's judgments around other known facts and circumstances associated with those loans, and loans 60 days or more past due (except for certain credit-enhanced loans). Recorded investment on impaired loans includes the unpaid principal balance plus amortized basis adjustments, which are modifications to the loan's carrying value.

Total loan loss reserves, as presented in "Table 5.2 — Detail of Loan Loss Reserves," consists of a specific valuation allowance related to impaired loans, which is presented in Table 5.3, and an additional reserve for other probable incurred losses, which totaled \$2,809 million, \$613 million and \$532 million at December 31, 2007, 2006 and 2005, respectively. Our recorded investment in impaired loans and the related valuation allowance are summarized in Table 5.3.

Table 5.3 — Impaired Loans

	December 31,								
	2007			2006 (Adjusted)			2005		
	Recorded Investment	Specific Reserve	Net Investment	Recorded Investment	Specific Reserve	Net Investment	Recorded Investment	Specific Reserve	Net Investment
(in millions)									
Impaired loans having:									
Related-valuation allowance	\$ 155	\$(13)	\$ 142	\$ 86	\$(6)	\$ 80	\$ 54	\$(16)	\$ 38
No related-valuation allowance ⁽¹⁾	8,579	—	8,579	5,818	—	5,818	2,536	—	2,536
Total	<u>\$8,734</u>	<u>\$(13)</u>	<u>\$8,721</u>	<u>\$5,904</u>	<u>\$(6)</u>	<u>\$5,898</u>	<u>\$2,590</u>	<u>\$(16)</u>	<u>\$2,574</u>

- (1) Impaired loans with no related valuation allowance primarily represent performing single-family troubled debt restructuring loans and those delinquent loans purchased out of PC pools that have not been impaired subsequent to acquisition.

For the years ended December 31, 2007, 2006 and 2005, the average recorded investment in impaired loans was \$7.5 billion, \$4.4 billion and \$2.6 billion, respectively. The increase in impaired loans in 2007 is attributed to an increase in the average size of the unpaid principal balance for loans originated in 2006 and 2007, and higher delinquency rates overall, but especially for loans originated in these years. The increase in impaired loans in 2006 is primarily attributed to higher volumes of delinquent loans in the North Central region, which was affected by a downturn in that area's economy.

Interest income on multifamily impaired loans is recognized on an accrual basis for loans performing under the original or restructured terms and on a cash basis for non-performing loans, which collectively totaled approximately \$22 million, \$25 million and \$24 million for the years ended December 31, 2007, 2006 and 2005, respectively. We recorded interest

income on impaired single-family loans that totaled \$382 million, \$177 million and \$149 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Interest income and management and guarantee income foregone on impaired loans approximated \$141 million, \$23 million and \$128 million in 2007, 2006 and 2005, respectively.

Loans Acquired under Financial Guarantees

We have the option under our PC agreements to purchase mortgage loans from the loan pools that underlie our guarantees and standby commitments under certain circumstances to resolve an existing or impending delinquency or default. Effective December 2007, our general practice is to purchase loans that are delinquent from pools when the loans have been modified or foreclosure sales occur, or when the loans have been delinquent for 24 months, unless we determine it is economically beneficial to do so sooner. Prior to December 2007, our general practice was to purchase the mortgage loans when the loans were significantly past due, generally after 120 days of delinquency. Loans purchased from PC pools that underlie our guarantees or that are covered by our standby commitments are recorded at fair value. We recognize losses on loans purchased in our consolidated statements of income if our net investment in the acquired loan is higher than its fair value. At December 31, 2007 and 2006, the unpaid principal balances of these loans were \$7.0 billion and \$3.0 billion, respectively, while the carrying amounts of these loans were \$5.2 billion and \$2.8 billion, respectively.

We account for loans acquired in accordance with SOP 03-3 if, at acquisition, the loans had credit deterioration and we do not consider it probable that we will collect all contractual cash flows from the borrower. The following table provides details on impaired loans acquired under financial guarantees.

Table 5.4 — Loans Acquired Under Financial Guarantees and Accounted for in Accordance with SOP 03-3

	Year Ended December 31,	
	2007	Adjusted 2006
	(in millions)	
Contractual principal and interest payments at acquisition	\$ 9,735	\$5,223
Non-accretable difference	(549)	(142)
Cash flows expected to be collected at acquisition	9,186	5,081
Accretable balance	(2,717)	(648)
Initial investment in acquired loans at acquisition	<u>\$ 6,469</u>	<u>\$4,433</u>

The excess of contractual principal and interest over the undiscounted amount of cash flows we expect to collect represents a non-accretable difference that is not accreted to interest income nor displayed on the consolidated balance sheets. The amount that may be accreted into interest income on such loans is limited to the excess of our estimate of undiscounted expected principal, interest and other cash flows from the loan over our initial investment in the loan. We consider estimated prepayments when calculating the accretable balance and the non-accretable difference. While these loans are seriously delinquent, no amounts are accreted to interest income. Subsequent changes in estimated future cash flows to be collected related to interest-rate changes are recognized prospectively in interest income over the remaining contractual life of the loan. Decreases in estimated future cash flows to be collected due to further credit deterioration are recognized as provision for credit losses and increase our loan loss reserve. Subsequent to acquisition, we recognized \$12 million in provision for credit losses on our consolidated statement of income related to these loans in 2007.

The following table provides changes in the accretable balance of these loans.

Table 5.5 — Changes in Accretable Balance

	Year Ended December 31,	
	2007	Adjusted 2006
	(in millions)	
Beginning balance	\$ 510	\$ —
Additions from new acquisitions	2,717	648
Accretion during the period	(193)	(104)
Reductions ⁽¹⁾	(504)	(58)
Change in estimated cash flows ⁽²⁾	121	31
Reclassifications to or from nonaccretable difference	(244)	(7)
Ending balance	<u>\$2,407</u>	<u>\$ 510</u>

(1) Represents the recapture of losses previously recognized due to borrower repayment or foreclosure on the loan. During 2006, these recoveries were included within our losses on loans purchased.

(2) Represents the change in expected cash flows due to troubled debt restructurings or change in prepayment assumptions of the related loans.

Delinquency Rates

Table 5.6 summarizes the delinquency performance for our total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities backed by Ginnie Mae Certificates.

Table 5.6 — Delinquency Performance

	At December 31,		
	2007	2006	2005
Delinquencies:			
Single-family: ⁽¹⁾			
Non-credit-enhanced portfolio — excluding Structured Transactions:			
Delinquency rate	0.45%	0.25%	0.30%
Total number of delinquent loans	44,948	22,671	25,977
Credit-enhanced portfolio — excluding Structured Transactions:			
Delinquency rate	1.62%	1.30%	1.61%
Total number of delinquent loans	34,621	24,106	29,336
Total portfolio — excluding Structured Transactions:			
Delinquency rate	0.65%	0.42%	0.53%
Total number of delinquent loans	79,569	46,777	55,313
Structured Transactions ⁽²⁾ :			
Delinquency rate	9.86%	8.36%	12.34%
Total number of delinquent loans	14,122	13,770	19,625
Total single-family portfolio ⁽²⁾ :			
Delinquency rate	0.76%	0.54%	0.71%
Total number of delinquent loans	93,691	60,547	74,938
Multifamily: ⁽³⁾			
Delinquency rate	0.02%	0.06%	—%
Net carrying value of delinquent loans (in millions)	\$ 10	\$ 30	\$ 2

- (1) Based on the number of mortgages 90 days or more delinquent or in foreclosure. Delinquencies on mortgage loans underlying certain Structured Securities, long-term standby commitments and Structured Transactions may be reported on a different schedule due to variances in industry practice.
- (2) Structured Transactions generally have underlying mortgage loans with higher risk characteristics but may provide inherent credit protections from losses due to underlying subordination, excess interest, overcollateralization and other features. Previously reported delinquency data for Structured Transactions excluded certain information when underlying loan servicing data was not previously available. Prior period information has been revised to conform to the current period presentation, which includes loan servicing data for all Structured Transactions.
- (3) Multifamily delinquency performance is based on net carrying value of mortgages 60 days or more delinquent, and excludes multifamily Structured Transactions, which are approximately 1%, 2% and —% of our total multifamily portfolio as of December 31, 2007, 2006 and 2005, respectively. There were no delinquencies for our multifamily Structured Transactions as of December 31, 2007, 2006 and 2005.

NOTE 6: REAL ESTATE OWNED

We obtain REO properties when we are the highest bidder at foreclosure sales of properties that collateralize non-performing single-family and multifamily mortgage loans owned by us. Upon acquiring single-family properties, we establish a marketing plan to sell the property as soon as practicable by either listing it with a sales broker or by other means, such as arranging a real estate auction. Upon acquiring multifamily properties, we may operate them with third-party property-management firms for a period to stabilize value and then sell the properties through commercial real estate brokers. For each of the years ended December 31, 2007 and 2006, the weighted average holding period for our disposed REO properties was less than one year. Table 6.1 provides a summary of our REO activity.

Table 6.1 — Real Estate Owned

	REO, Gross	Valuation Allowance (in millions)	REO, Net
Balance, December 31, 2005	\$ 744	\$(115)	\$ 629
Additions	1,484	(85)	1,399
Dispositions and write-downs	(1,357)	72	(1,285)
Balance, December 31, 2006	\$ 871	\$(128)	\$ 743
Additions	2,906	(175)	2,731
Dispositions and write-downs	(1,710)	(28)	(1,738)
Balance, December 31, 2007	\$ 2,067	\$(331)	\$ 1,736

We recognized net losses of \$120 million, \$59 million and \$67 million on REO dispositions for the years ended December 31, 2007, 2006 and 2005, respectively, which are included in REO operations expense. The number of REO property additions increased by 39% in 2007 compared to those in 2006. Our REO additions have continued to be greatest in the North Central region of the U.S. and approximately 43% of our REO property count balance relates to properties located in this region.

NOTE 7: DEBT SECURITIES AND SUBORDINATED BORROWINGS

Table 7.1 summarizes the balances and effective interest rates for debt securities, as well as subordinated borrowings.

Table 7.1 — Total Debt Securities, Net

	December 31,			
	2007		2006	
	Balance, Net ⁽¹⁾	Effective Rate ⁽²⁾	Balance, Net ⁽¹⁾	Effective Rate ⁽²⁾
	(dollars in millions)			
Senior debt, due within one year:				
Short-term debt securities	\$197,601	4.52%	\$167,385	5.14%
Current portion of long-term debt	98,320	4.44	117,879	4.10
Senior debt, due within one year	295,921	4.49	285,264	4.71
Senior debt, due after one year	438,147	5.24	452,677	5.08
Subordinated debt, due after one year	4,489	5.84	6,400	5.86
Senior and subordinated debt, due after one year	442,636	5.25	459,077	5.09
Total debt securities, net	<u>\$738,557</u>		<u>\$744,341</u>	

(1) Represents par value, net of associated discounts, premiums and foreign-currency-related basis adjustments.

(2) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs.

Senior Debt, Due Within One Year

As indicated in Table 7.2, a majority of senior debt, due within one year (excluding current portion of long-term debt) consisted of Reference Bills[®] securities and discount notes, paying only principal at maturity. Reference Bills[®] securities, discount notes and medium-term notes are unsecured general corporate obligations. Certain medium-term notes that have original maturities of one year or less are classified as short-term debt securities. Securities sold under agreements to repurchase are effectively collateralized borrowing transactions where we sell securities with an agreement to repurchase such securities. These agreements require the underlying securities to be delivered to the dealers who arranged the transactions. Federal funds purchased are unsecuritized borrowings from commercial banks that are members of the Federal Reserve System. At both December 31, 2007 and 2006, the balance of securities sold under agreements to repurchase and federal funds purchased was \$—.

Table 7.2 provides additional information related to our debt securities due within one year.

Table 7.2 — Senior Debt, Due Within One Year

	December 31,					
	2007			2006		
	Par Value	Balance, Net ⁽¹⁾	Effective Rate	Par Value	Balance, Net ⁽¹⁾	Effective Rate
	(dollars in millions)					
Reference Bills [®] securities and discount notes ⁽²⁾	\$198,323	\$196,426	4.52%	\$159,503	\$157,553	5.14%
Medium-term notes ⁽²⁾	1,175	1,175	4.36	9,832	9,832	5.16
Short-term debt securities	199,498	197,601	4.52	169,335	167,385	5.14
Current portion of long-term debt	97,262	98,320	4.44	117,972	117,879	4.10
Senior debt, due within one year	<u>\$296,760</u>	<u>\$295,921</u>	4.49	<u>\$287,307</u>	<u>\$285,264</u>	4.71

(1) Represents par value, net of associated discounts, premiums and foreign-currency-related basis adjustments.

(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.

Senior and Subordinated Debt, Due After One Year

Table 7.3 summarizes our senior and subordinated debt, due after one year.

Table 7.3 — Senior and Subordinated Debt, Due After One Year

	Contractual Maturity ⁽¹⁾	December 31,					
		2007			2006		
		Par Value	Balance, Net ⁽²⁾	Interest Rates	Par Value	Balance, Net ⁽²⁾	Interest Rates
(dollars in millions)							
Senior debt, due after one year: ⁽³⁾							
Fixed-rate:							
Medium-term notes — callable ⁽⁴⁾	2009 – 2037	\$169,588	\$169,519	3.00% – 7.50%	\$183,611	\$183,532	2.57% – 7.50%
Medium-term notes — non-callable	2009 – 2028	7,122	7,399	1.00% – 14.32%	5,764	5,798	1.00% – 10.27%
U.S. dollar Reference Notes® securities — non-callable	2009 – 2032	202,139	201,745	3.38% – 7.00%	195,289	194,772	2.75% – 7.00%
€Reference Notes® securities — non-callable	2009 – 2014	9,670	9,649	3.75% – 5.75%	16,912	16,878	3.50% – 5.75%
Variable-rate:							
Medium-term notes — callable ⁽⁵⁾	2009 – 2030	22,913	22,909	Various	28,617	28,616	Various
Medium-term notes — non-callable	2009 – 2026	2,653	2,688	Various	421	460	Various
Zero-coupon:							
Medium-term notes — callable ⁽⁶⁾	2014 – 2037	45,725	9,544	—%	43,248	8,610	—%
Medium-term notes — non-callable ⁽⁷⁾	2009 – 2037	14,493	9,556	—%	10,535	6,204	—%
Foreign-currency-related and hedging-related basis adjustments		N/A	5,138		N/A	7,807	
Total senior debt, due after one year		474,303	438,147		484,397	452,677	
Subordinated debt, due after one year:							
Fixed-rate ⁽⁸⁾	2011 – 2018	4,452	4,388	5.00% – 8.25%	6,382	6,309	5.00% – 8.25%
Zero-coupon ⁽⁹⁾	2019	332	101	—%	332	91	—%
Total subordinated debt, due after one year		4,784	4,489		6,714	6,400	
Total senior and subordinated debt, due after one year		\$479,087	\$442,636		\$491,111	\$459,077	

(1) Represents contractual maturities at December 31, 2007.

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

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

(4) Includes callable Estate NotesSM securities and FreddieNotes® securities of \$14.1 billion and \$13.0 billion at December 31, 2007 and 2006, respectively. These debt instruments represent medium-term notes that permit persons acting on behalf of deceased beneficial owners to require us to repay principal prior to the contractual maturity date.

(5) Includes callable Estate NotesSM securities and FreddieNotes® securities of \$6.3 billion and \$7.8 billion at December 31, 2007 and 2006.

(6) The effective rates for zero-coupon medium-term notes — callable ranged from 5.57% – 7.17% at both December 31, 2007 and 2006.

(7) The effective rates for zero-coupon medium-term notes — non-callable ranged from 3.46% – 10.68% and 2.65% – 10.68% at December 31, 2007 and 2006, respectively.

(8) Balance, net includes callable subordinated debt of \$— and \$1.9 billion at December 31, 2007 and 2006, respectively.

(9) The effective rate for zero-coupon subordinated debt, due after one year was 10.20% at both December 31, 2007 and 2006.

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

Table 7.4 summarizes the contractual maturities of long-term debt securities (including current portion of long-term debt) and subordinated borrowings outstanding at December 31, 2007, assuming callable debt is paid at contractual maturity.

Table 7.4 — Senior and Subordinated Debt, Due After One Year (including current portion of long-term debt)

Annual Maturities	Contractual Maturity ⁽¹⁾⁽²⁾ (in millions)
2008	\$ 97,262
2009	79,316
2010	63,911
2011	45,966
2012	52,317
Thereafter	237,577
Total ⁽¹⁾	576,349
Net discounts, premiums and foreign-currency-related basis adjustments ⁽²⁾	(35,393)
Senior and subordinated debt, due after one year, including current portion of long-term debt	\$540,956

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

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

Lines of Credit

We opened intraday lines of credit with third-parties to provide additional liquidity to fund our intraday activities through the Fedwire system in connection with the Federal Reserve Board's revised payments system risk policy, which restricts or eliminates daylight overdrafts by GSEs, including us. At December 31, 2007, we had two secured, uncommitted lines of credit totaling \$17 billion. No amounts were drawn on these lines of credit at December 31, 2007. We expect to

continue to use these facilities from time to time to satisfy our intraday financing needs; however, since the lines are uncommitted, we may not be able to draw on them if and when needed.

NOTE 8: STOCKHOLDERS' EQUITY

Preferred Stock

During 2007, we completed five preferred stock offerings consisting of five classes. We had two preferred stock offerings consisting of three classes during 2006. All 24 classes of preferred stock outstanding at December 31, 2007 have a par value of \$1 per share. We have the option to redeem these shares, on specified dates, at their redemption price plus dividends accrued through the redemption date. In addition, all 24 classes of preferred stock are perpetual and non-cumulative, and carry no significant voting rights or rights to purchase additional Freddie Mac stock or securities. Costs incurred in connection with the issuance of preferred stock are charged to additional paid-in capital.

Table 8.1 provides a summary of our preferred stock outstanding at December 31, 2007.

Table 8.1 — Preferred Stock

	<u>Issue Date</u>	<u>Shares Authorized</u>	<u>Shares Outstanding</u>	<u>Total Par Value</u>	<u>Redemption Price per Share</u>	<u>Total Outstanding Balance⁽¹⁾</u>	<u>Redeemable On or After⁽²⁾</u>	<u>NYSE Symbol⁽³⁾</u>
(in millions, except redemption price per share)								
1996 Variable-rate ⁽⁴⁾	April 26, 1996	5.00	5.00	\$ 5.00	\$50.00	\$ 250	June 30, 2001	FRE.prB
5.81%	October 27, 1997	3.00	3.00	3.00	50.00	150	October 27, 1998	(5)
5%	March 23, 1998	8.00	8.00	8.00	50.00	400	March 31, 2003	FRE.prF
1998 Variable-rate ⁽⁶⁾	September 23 and 29, 1998	4.40	4.40	4.40	50.00	220	September 30, 2003	FRE.prG
5.10%	September 23, 1998	8.00	8.00	8.00	50.00	400	September 30, 2003	FRE.prH
5.30%	October 28, 1998	4.00	4.00	4.00	50.00	200	October 30, 2000	(5)
5.10%	March 19, 1999	3.00	3.00	3.00	50.00	150	March 31, 2004	(5)
5.79%	July 21, 1999	5.00	5.00	5.00	50.00	250	June 30, 2009	FRE.prK
1999 Variable-rate ⁽⁷⁾	November 5, 1999	5.75	5.75	5.75	50.00	287	December 31, 2004	FRE.prL
2001 Variable-rate ⁽⁸⁾	January 26, 2001	6.50	6.50	6.50	50.00	325	March 31, 2003	FRE.prM
2001 Variable-rate ⁽⁹⁾	March 23, 2001	4.60	4.60	4.60	50.00	230	March 31, 2003	FRE.prN
5.81%	March 23, 2001	3.45	3.45	3.45	50.00	173	March 31, 2011	FRE.prO
6%	May 30, 2001	3.45	3.45	3.45	50.00	173	June 30, 2006	FRE.prP
2001 Variable-rate ⁽¹⁰⁾	May 30, 2001	4.02	4.02	4.02	50.00	201	June 30, 2003	FRE.prQ
5.70%	October 30, 2001	6.00	6.00	6.00	50.00	300	December 31, 2006	FRE.prR
5.81%	January 29, 2002	6.00	6.00	6.00	50.00	300	March 31, 2007	(5)
2006 Variable-rate ⁽¹¹⁾	July 17, 2006	15.00	15.00	15.00	50.00	750	June 30, 2011	FRE.prS
6.42%	July 17, 2006	5.00	5.00	5.00	50.00	250	June 30, 2011	FRE.prT
5.90%	October 16, 2006	20.00	20.00	20.00	25.00	500	September 30, 2011	FRE.prU
5.57%	January 16, 2007	44.00	44.00	44.00	25.00	1,100	December 31, 2011	FRE.prV
5.66%	April 16, 2007	20.00	20.00	20.00	25.00	500	March 31, 2012	FRE.prW
6.02%	July 24, 2007	20.00	20.00	20.00	25.00	500	June 30, 2012	FRE.prX
6.55%	September 28, 2007	20.00	20.00	20.00	25.00	500	September 30, 2017	FRE.prY
2007 Fixed-to-floating Rate ⁽¹²⁾	December 4, 2007	<u>240.00</u>	<u>240.00</u>	<u>240.00</u>	25.00	<u>6,000</u>	December 31, 2012	FRE.prZ
Total		<u>464.17</u>	<u>464.17</u>	<u>\$464.17</u>		<u>\$14,109</u>		

- (1) Amounts stated at redemption value.
- (2) As long as the capital monitoring framework established by OFHEO in January 2004 remains in effect, any preferred stock redemption will require prior approval by OFHEO. See "NOTE 9: REGULATORY CAPITAL" for more information.
- (3) Preferred stock is listed on the New York Stock Exchange, or NYSE, unless otherwise noted.
- (4) Dividend rate resets quarterly and is equal to the sum of three-month London Interbank Offered Rate, or LIBOR, plus 1% divided by 1.377, and is capped at 9.00%.
- (5) Not listed on any exchange.
- (6) Dividend rate resets quarterly and is equal to the sum of three-month LIBOR plus 1% divided by 1.377, and is capped at 7.50%.
- (7) Dividend rate resets on January 1 every five years after January 1, 2005 based on a five-year Constant Maturity Treasury, or CMT, rate, and is capped at 11.00%. Optional redemption on December 31, 2004 and on December 31 every five years thereafter.
- (8) Dividend rate resets on April 1 every two years after April 1, 2003 based on the two-year CMT rate plus 0.10%, and is capped at 11.00%. Optional redemption on March 31, 2003 and on March 31 every two years thereafter.
- (9) Dividend rate resets on April 1 every year based on 12-month LIBOR minus 0.20%, and is capped at 11.00%. Optional redemption on March 31, 2003 and on March 31 every year thereafter.
- (10) Dividend rate resets on July 1 every two years after July 1, 2003 based on the two-year CMT rate plus 0.20%, and is capped at 11.00%. Optional redemption on June 30, 2003 and on June 30 every two years thereafter.
- (11) Dividend rate resets quarterly and is equal to the sum of three-month LIBOR plus 0.50% but not less than 4.00%.
- (12) Dividend rate is set at an annual fixed rate of 8.375% from December 4, 2007 through December 31, 2012. For the period beginning on or after January 1, 2013, dividend rate resets quarterly and is equal to the higher of (a) the sum of three-month LIBOR plus 4.16% per annum or (b) 7.875% per annum. Optional redemption on December 31, 2012, and on December 31 every five years thereafter.

Stock Repurchase and Issuance Programs

During 2007, we completed five non-cumulative, perpetual preferred stock offerings with aggregate proceeds of \$8.6 billion, including \$6.0 billion of fixed-to-floating to increase our capital position and \$500 million of 6.55% non-cumulative, perpetual preferred stock for general corporate purposes. We also issued \$500 million of 6.02% and \$500 million of 5.66% non-cumulative, perpetual preferred stock and repurchased \$1.0 billion (approximately 16.1 million shares) of outstanding common stock, thereby completing our plan announced in March 2007 to replace \$1.0 billion of common stock

with an equal amount of preferred stock. In addition, we issued \$1.1 billion of 5.57% non-cumulative, perpetual preferred stock, consisting of \$500 million to complete our plan announced in October 2005 to replace \$2.0 billion of common stock with an equal amount of preferred stock and \$600 million to replace higher-cost preferred stock that we redeemed.

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 our plan announced in October 2005 to replace \$2.0 billion of common stock with an equal amount of preferred stock.

In accordance with OFHEO's capital monitoring framework, we obtained OFHEO's approval for the preferred stock redemption and common stock repurchase activities described above.

Common Stock Dividends Declared

Common stock dividends declared per share were \$1.75, \$1.91 and \$1.52 for 2007, 2006 and 2005, respectively.

NOTE 9: REGULATORY CAPITAL

Regulatory Capital Standards

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

Those standards determine the amounts of core capital and total capital that we must maintain to meet regulatory capital requirements. Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), the par value of outstanding non-cumulative, perpetual preferred stock, additional paid-in capital and retained earnings, as determined in accordance with GAAP. Total capital includes core capital and general reserves for mortgage and foreclosure losses and any other amounts available to absorb losses that OFHEO includes by regulation.

Minimum Capital

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

Critical Capital

The critical capital standard requires us to hold an amount of core capital that is generally equal to the sum of 1.25% of aggregate on-balance sheet assets and approximately 0.25% of the sum of our PCs and Structured Securities outstanding and other aggregate off-balance sheet obligations.

Risk-Based Capital

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

Classification

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

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

If we were classified as adequately capitalized, we generally could pay a dividend on our common or preferred stock or make other capital distributions (which includes common stock repurchases and preferred stock redemptions) without prior

OFHEO approval so long as the payment would not decrease total capital to an amount less than our risk-based capital requirement and would not decrease our core capital to an amount less than our minimum capital requirement. However, because we are currently subject to the regulatory capital monitoring framework described below, we are required to obtain OFHEO's prior approval of certain capital transactions, including common stock repurchases, redemption of any preferred stock or payment of dividends on preferred stock above stated contractual rates.

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

If we were classified as significantly undercapitalized, we would be prohibited from making any capital distribution that would reduce our core capital to less than the critical capital level. We would otherwise be able to make a capital distribution only if OFHEO determined that the distribution would: (a) enhance our ability to meet the risk-based capital standard and the minimum capital standard promptly; (b) contribute to our long-term financial safety and soundness; or (c) otherwise be in the public interest. Also under this classification, OFHEO could take action to limit our growth, require us to acquire new capital or restrict us from activities that create excessive risk. We also would be required to submit a capital restoration plan for OFHEO approval, which could adversely affect our ability to make capital distributions.

If we were classified as critically undercapitalized, OFHEO would be required to appoint a conservator for us, unless OFHEO made a written finding that it should not do so and the Secretary of the Treasury concurred in that determination. We would be able to make a capital distribution only if OFHEO determined that the distribution would: (a) enhance our ability to meet the risk-based capital standard and the minimum capital standard promptly; (b) contribute to our long-term financial safety and soundness; or (c) otherwise be in the public interest.

Performance Against Regulatory Capital Standards

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

Table 9.1 summarizes our regulatory capital requirements and surpluses.

Table 9.1 — Regulatory Capital Requirements⁽¹⁾

	December 31,	
	2007	(Adjusted) 2006
	(in millions)	
<i>Minimum capital requirement⁽²⁾</i>	\$26,473	\$25,607
Core capital ⁽²⁾	37,867	35,365
Minimum capital surplus ⁽²⁾	11,394	9,758
<i>Critical capital requirement⁽²⁾</i>	\$13,618	\$13,119
Core capital ⁽²⁾	37,867	35,365
Critical capital surplus ⁽²⁾	24,249	22,246
<i>Risk-based capital requirement⁽³⁾</i>	N/A	\$15,320
Total capital ⁽³⁾	N/A	36,742
Risk-based capital surplus ⁽³⁾	N/A	21,422

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

(2) Amounts for 2007 and 2006 are based on amended reports we will submit to OFHEO.

(3) OFHEO determines the amounts reported with respect to our risk-based capital requirement. Amounts for 2007 are not yet available and amounts for 2006 are those calculated by OFHEO prior to the adjustment of our 2006 financial results.

Factors that could adversely affect the adequacy of our capital in future periods include GAAP net losses; continued declines in home prices; increases in our credit and interest-rate risk profiles; adverse changes in interest-rate or implied volatility; adverse option-adjusted spread, or OAS, changes; legislative or regulatory actions that increase capital requirements; or changes in accounting practices or standards. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Recently Issued Accounting Standards, Not Yet Adopted" for more information. In particular, interest-rate levels or implied volatility can affect the amount of our core capital, even if we were economically well hedged against interest-rate changes, because certain gains or losses are recognized through GAAP earnings while other offsetting gains or losses may not be. Changes in OAS can also affect the amount of our core capital, because OAS are a factor in the valuation of our guaranteed mortgage portfolio.

Subordinated Debt Commitment

In October 2000, we announced our voluntary adoption of a series of commitments designed to enhance market discipline, liquidity and capital. In September 2005, we entered into a written agreement with OFHEO that updated those commitments and set forth a process for implementing them. Under the terms of this agreement, we committed to issue qualifying subordinated debt for public secondary market trading and rated by no fewer than two nationally recognized

statistical rating organizations in a quantity such that the sum of total capital plus the outstanding balance of qualifying subordinated debt will equal or exceed the sum of 0.45% of our PCs and Structured Securities outstanding and 4% of our on-balance sheet assets at the end of each quarter. Qualifying subordinated debt is defined as subordinated debt that contains a deferral of interest payments for up to five years if our core capital falls below 125% of our critical capital requirement or our core capital falls below our minimum capital requirement and pursuant to our request, the Secretary of the Treasury exercises discretionary authority to purchase our obligations under Section 306(c) of our charter. Qualifying subordinated debt will be discounted for the purposes of this commitment as it approaches maturity with one-fifth of the outstanding amount excluded each year during the instrument's last five years before maturity. When the remaining maturity is less than one year, the instrument is entirely excluded.

Table 9.2 summarizes our compliance with our subordinated debt commitment.

Table 9.2 — Subordinated Debt Commitment

	December 31,	
	(Adjusted)	
	2007	2006
	(in millions)	
Total on-balance sheet assets and PCs and Structured Securities outstanding target ⁽¹⁾⁽²⁾	\$38,000	\$37,249
Total capital plus qualifying subordinated debt ⁽²⁾	44,559	41,997
Surplus ⁽²⁾	6,559	4,748

(1) Equals the sum of 0.45% of our PCs and Structured Securities held by third parties and 4% of on-balance sheet assets.

(2) Amounts for 2007 and 2006 are based on amended reports we will submit to OFHEO.

Regulatory Capital Monitoring Framework

In a letter dated January 28, 2004, OFHEO created a framework for monitoring our capital. The letter directed that we maintain a 30% mandatory target capital surplus over our minimum capital requirement, subject to certain conditions and variations; that we submit weekly reports concerning our capital levels; and that we obtain prior approval of certain capital transactions.

Our failure to meet the 30% mandatory target capital surplus would result in an OFHEO inquiry regarding the reason for such failure. If OFHEO were to determine that we had acted unreasonably regarding our compliance with the framework, as set forth in OFHEO's letter, OFHEO could seek to require us to submit a remedial plan or take other remedial steps.

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

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

Table 9.3 summarizes our compliance with the 30% mandatory target capital surplus portion of OFHEO's capital monitoring framework.

Table 9.3 — Mandatory Target Capital Surplus

	December 31,	
	(Adjusted)	
	2007	2006
	(in millions)	
Minimum capital requirement plus 30% add-on ⁽¹⁾	\$34,415	\$33,289
Core capital ⁽¹⁾	37,867	35,365
Surplus ⁽¹⁾	3,452	2,076

(1) Amounts for 2007 and 2006 are based on amended reports we will submit to OFHEO.

NOTE 10: STOCK-BASED COMPENSATION

We have three stock-based compensation plans under which grants are being made: (a) the ESPP; (b) the 2004 Stock Compensation Plan, or 2004 Employee Plan; and (c) the 1995 Directors' Stock Compensation Plan, as amended and restated, or Directors' Plan. Prior to the stockholder approval of the 2004 Employee Plan, employee stock-based compensation was awarded in accordance with the terms of the 1995 Stock Compensation Plan, or 1995 Employee Plan. Although grants are no longer made under the 1995 Employee Plan, we currently have awards outstanding under this plan. We collectively refer to the 2004 Employee Plan and 1995 Employee Plan as the Employee Plans.

Common stock delivered under these plans may consist of authorized but previously unissued shares, treasury stock or shares acquired in market transactions on behalf of the participants. During 2007, we granted restricted stock units as stock-based awards. Such awards, discussed below, are generally forfeitable for at least one year after the grant date, with vesting provisions contingent upon service requirements.

Stock Options

Stock options granted allow for the purchase of our common stock at an exercise price equal to the fair market value of our common stock on the grant date. During 2006, the 2004 Employee Plan was amended to change the definition of fair market value to the closing sales price of a share of common stock from the average of the high and low sales prices, effective for all grants after December 6, 2006. Options generally may be exercised for a period of 10 years from the grant date, subject to a vesting schedule commencing on the grant date.

Stock options that we previously granted included dividend equivalent rights. Depending on the terms of the grant, the dividend equivalents may be paid when and as dividends on our common stock are declared. Alternatively, dividend equivalents may be paid upon exercise or expiration of the stock option. Subsequent to November 30, 2005, dividend equivalent rights were no longer granted in connection with awards of stock options to grantees to address Internal Revenue Code Section 409A.

Restricted Stock Units

A restricted stock unit entitles the grantee to receive one share of common stock at a specified future date. Restricted stock units do not have voting rights, but do have dividend equivalent rights, which are (a) paid to restricted stock unit holders who are employees as and when dividends on common stock are declared or (b) accrued as additional restricted stock units for non-employee members of our board of directors.

Restricted Stock

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

Stock-Based Compensation Plans

The following is a description of each of our stock-based compensation plans under which grants are currently being made.

ESPP

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

At December 31, 2007, the maximum number of shares of common stock authorized for grant to employees totaled 6.8 million shares, of which approximately 0.7 million shares had been issued and approximately 6.1 million shares remained available for grant. At December 31, 2007, no options to purchase stock were exercisable under the ESPP, as the options to purchase stock outstanding at year-end become exercisable subsequent to year-end, and are exercised or forfeited during the subsequent year.

2004 Employee Plan

Under the 2004 Employee Plan, we may grant employees stock-based awards, including stock options, restricted stock units and restricted stock. In addition, we have the right to impose performance conditions with respect to these awards. Employees may also be granted stock appreciation rights; however, at December 31, 2007, no stock appreciation rights had been granted under the 2004 Employee Plan. At December 31, 2007, the maximum number of shares of common stock authorized for grant to employees in accordance with the 2004 Employee Plan totaled 14.5 million shares, of which approximately 4.2 million shares had been issued and approximately 10.3 million shares remained available for grant.

Directors' Plan

Under the Directors' Plan, we are permitted to grant stock options, restricted stock units and restricted stock to non-employee members of our board of directors. At December 31, 2007, the maximum number of shares of common stock authorized for grant to members of our board of directors in accordance with the Directors' Plan totaled 2.4 million shares, of which approximately 0.9 million shares had been issued and approximately 1.5 million shares remained available for grant.

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

Estimates used to determine the assumptions noted in the table below are determined as follows:

- (a) the expected volatility is based on the historical volatility of the stock over a time period equal to the expected life;
- (b) the weighted average volatility is the weighted average of the expected volatility;
- (c) the weighted average expected dividend yield is based on the most recent dividend announcement relative to the grant date and the stock price at the grant date;
- (d) the weighted average expected life is based on historical option exercise experience; and
- (e) the weighted average risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant.

Changes in the assumptions used to calculate the fair value of stock options could result in materially different fair value estimates. The actual value of stock options will depend on the market value of our common stock when the stock options are exercised.

Table 10.1 summarizes the assumptions used in determining the fair values of options granted under our stock-based compensation plans using a Black-Scholes option-pricing model as well as the weighted average grant-date fair value of options granted and the total intrinsic value of options exercised.

Table 10.1 — Assumptions and Valuations

	ESPP			Employee Plans and Directors’ Plan		
	2007	2006	2005	2007 ⁽¹⁾	2006	2005 ⁽²⁾
	(dollars in millions, except share-related amounts)					
Assumptions:						
Expected volatility	11.1% to 45.4%	11.2% to 18.7%	16.8% to 21.1%	N/A	27.8% to 28.9%	18.4% to 30.3%
Weighted average:						
Volatility	26.22%	15.7%	19.7%	N/A	28.7%	30.0%
Expected dividend yield	3.44%	2.98%	2.15%	N/A	3.09%	—
Expected life	3 months	3 months	3 months	N/A	7.1 years	7.4 years
Risk-free interest rate	4.57%	4.82%	3.20%	N/A	4.91%	4.23%
Valuations:						
Weighted average grant-date fair value of options granted	\$11.25	\$11.20	\$11.56	N/A	\$16.78	\$26.84
Total intrinsic value of options exercised	\$2	\$3	\$2	\$7	\$20	\$32

- (1) No options were granted under the Employee Plans and Directors’ Plan.
- (2) The value of the dividend equivalent feature of options for the Employee Plans and Directors’ Plan was incorporated into the Black-Scholes model by using an expected dividend yield of —%. To account for a modification of stock options on November 30, 2005, the dividend equivalent feature of affected stock options for the Employee Plans and Directors’ Plan was valued separately. Other assumptions used to value the affected stock options were as follows: (a) expected volatility of 25.4%, (b) expected dividend yield of 2.96%, (c) expected life of 5.1 years and (d) risk-free interest rate of 4.34%. Subsequent to November 30, 2005, dividend equivalent rights are no longer granted in connection with new awards of stock options to grantees.

Table 10.2 provides a summary of activity under the ESPP for the year ended December 31, 2007 and those options to purchase stock that are exercisable at December 31, 2007.

Table 10.2 — ESPP Activity

	Options to Purchase Stock	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
	(dollars in millions, except share-related amounts)			
Outstanding at January 1, 2007 ⁽¹⁾	52,898	\$58.09		
Granted ⁽¹⁾	277,091	49.73		
Exercised	(238,913)	50.73		
Forfeited or expired	(8,510)	51.78		
Outstanding at December 31, 2007 ⁽¹⁾	82,566	42.71	1 month	\$—
Exercisable at December 31, 2007	—	—	—	\$—

- (1) Weighted average exercise price noted for options to purchase stock granted under the ESPP is calculated based on the average price on the grant date.

Table 10.3 provides a summary of option activity under the Employee Plans and Directors' Plan for the year ended December 31, 2007, and options exercisable at December 31, 2007.

Table 10.3 — Employee Plans and Directors' Plan Option Activity

	<u>Stock Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value</u>
	(dollars in millions, except share-related amounts)			
Outstanding at January 1, 2007	5,851,925	\$58.43		
Granted	—	—		
Exercised	(390,891)	45.67		
Forfeited or expired	(366,179)	61.73		
Outstanding at December 31, 2007	<u>5,094,855</u>	59.17	4.82 years	\$—
Exercisable at December 31, 2007	4,070,825	58.84	4.25 years	\$—

We received cash of \$18 million from the exercise of stock options under the Employee Plans and the Directors' Plan during 2007. We realized a tax benefit of \$2 million as a result of tax deductions available to us upon the exercise of stock options under the Employee Plans and the Directors' Plan during 2007. During 2007 and 2006, we did not pay cash to settle share-based liability awards granted under share-based payment arrangements associated with the Employee Plans and the Directors' Plan. During 2005, we paid \$1 million to settle share-based awards.

Table 10.4 provides a summary of activity related to restricted stock units and restricted stock under the Employee Plans and the Directors' Plan.

Table 10.4 — Employee Plans and Directors' Plan Restricted Stock Units and Restricted Stock Activity

	<u>Restricted Stock Units</u>	<u>Weighted Average Grant-Date Fair Value</u>	<u>Restricted Stock</u>	<u>Weighted Average Grant-Date Fair Value</u>
Outstanding at January 1, 2007	2,404,575	\$63.35	41,160	\$60.75
Granted ⁽¹⁾	1,592,659	58.84	—	—
Lapse of restrictions	(773,660)	63.76	—	—
Forfeited	(325,681)	61.37	—	—
Outstanding at December 31, 2007	<u>2,897,893</u>	60.96	<u>41,160</u>	60.75

(1) During 2007, restricted stock units granted under the Employee Plans and the Directors' Plan were 1,572,232 and 20,427, respectively.

The total fair value of restricted stock units vested during 2007, 2006 and 2005 was \$44 million, \$24 million and \$42 million, respectively. No restricted stock vested in 2007. The total fair value of restricted stock vested during 2006 and 2005 was \$2 million and \$5 million, respectively. We realized a tax benefit of \$15 million and \$9 million, respectively, as a result of tax deductions available to us upon the lapse of restrictions on restricted stock units and restricted stock under the Employee Plans and the Directors' Plan during 2007 and 2006.

Table 10.5 provides information on compensation expense related to stock-based compensation plans.

Table 10.5 — Compensation Expense Related to Stock-based Compensation

	<u>Year Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(in millions)		
Stock-based compensation expense recorded on our consolidated statements of stockholders' equity	\$81	\$60	\$67
Other stock-based compensation expense ⁽¹⁾	<u>1</u>	<u>3</u>	<u>2</u>
Total stock-based compensation expense ⁽²⁾	<u>\$82</u>	<u>\$63</u>	<u>\$69</u>
Tax benefit related to compensation expense recognized on our consolidated statements of income	\$28	\$21	\$23
Compensation expense capitalized within other assets on our consolidated balance sheets	7	5	5

(1) For 2007 and 2006, primarily consisted of dividend equivalents paid on stock options and restricted stock units that have been or are expected to be forfeited. Also included expense related to share-based liability awards granted under share-based payment arrangements.

(2) Component of salaries and employee benefits expense as recorded on our consolidated statements of income.

As of December 31, 2007, \$107 million of compensation expense related to non-vested awards had not yet been recognized in earnings. This amount is expected to be recognized in earnings over the next four years. During 2007, the modifications of individual awards, which provided for continued or accelerated vesting, were made to fewer than 60 employees and resulted in a reduction of compensation expense of \$0.3 million. During 2006, the modification of individual awards, which provided for continued or accelerated vesting, was made to fewer than 20 employees and resulted in incremental compensation expense of \$0.1 million.

NOTE 11: DERIVATIVES

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

- LIBOR- and the Euro Interbank Offered Rate, or Euribor-, based interest-rate swaps;
- LIBOR- and Treasury-based options (including swaptions);
- LIBOR- and Treasury-based exchange-traded futures; and
- Foreign-currency swaps.

Our derivative portfolio also includes certain forward purchase and sale commitments and other contractual agreements, including credit derivatives and swap guarantee derivatives in which we guarantee the sponsor's or the borrower's performance as a counterparty on certain interest-rate swaps.

At December 31, 2007, we did not have any derivatives in hedge accounting relationships. However, there are amounts recorded in AOCI related to terminated or de-designated cash flow relationships. These deferred gains and losses on closed cash flow hedges are recognized in earnings as the originally forecasted transactions affect earnings. During 2006 and 2005, we discontinued hedge accounting for substantially all of our hedge relationships. We record changes in the fair value of derivatives not in hedge accounting relationships as derivative gains (losses) on our consolidated statements of income. Any associated interest received or paid is recognized on an accrual basis and also recorded in derivative gains (losses) on our consolidated statements of income.

The carrying value of our derivatives on our consolidated balance sheets is equal to their fair value, including net derivative interest receivable or payable and is net of cash collateral held or posted, where allowable by a master netting agreement. Derivatives in a net asset position are reported as derivative assets, net. Similarly, derivatives in a net liability position are reported as derivative liabilities, net.

Cash collateral we obtained from counterparties to derivative contracts that has been offset against derivative assets, net at December 31, 2007 and December 31, 2006 was \$6.5 billion and \$9.6 billion, respectively. Cash collateral we posted to counterparties to derivative contracts that has been offset against derivative liabilities, net at December 31, 2007 and December 31, 2006 was \$344 million and \$57 million, respectively.

At December 31, 2007 and December 31, 2006, there were no amounts of cash collateral that were not offset against derivative assets, net or derivative liabilities, net, as applicable. See "NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS" for further information related to our derivative counterparties.

As shown in Table 11.1, the total AOCI, net of taxes, related to cash flow hedge relationships was a loss of \$4.1 billion at December 31, 2007, composed of deferred net losses on closed cash flow hedges. Closed cash flow hedges involve derivatives that have been terminated or are no longer designated as cash flow hedges. Fluctuations in prevailing market interest rates have no impact on the deferred portion of AOCI relating to losses on closed cash flow hedges.

Over the 12 months beginning January 1, 2008, we estimate that approximately \$865 million of deferred losses in AOCI, net of taxes, will be reclassified into earnings. The maximum remaining length of time over which we have hedged the exposure related to the variability in future cash flows on forecasted transactions, primarily interest payments on forecasted debt issuances, is 26 years. However, over 70% and 90% of the AOCI, net of taxes, balance relating to cash flow hedges at December 31, 2007 is linked to forecasted transactions occurring in the next five and ten years, respectively. The occurrence of forecasted transactions may be satisfied by either periodic issuances of short-term debt over the required time period or longer-term debt, such as Reference Notes[®] securities.

Table 11.1 presents the changes in AOCI, net of taxes, related to derivatives designated as cash flow hedges. Net change in fair value related to cash flow hedging activities, net of tax, represents the net change in the fair value of the derivatives that were designated as cash flow hedges, after the effects of our federal statutory tax rate of 35%, to the extent the hedges were effective. Net reclassifications of losses to earnings, net of tax, represents the AOCI amount, after the effects of our federal statutory tax rate of 35%, that was recognized in earnings as the originally hedged forecasted transactions affected earnings, unless it was deemed probable that the forecasted transaction would not occur. If it is probable that the forecasted transaction will not occur, then the deferred gain or loss associated with the hedge related to the forecasted transaction would be reclassified into earnings immediately.

Table 11.1 — AOCI, Net of Taxes, Related to Cash Flow Hedge Relationships

	Year Ended December 31,		
	2007	Adjusted	
		2006	2005
		(in millions)	
Beginning balance ⁽¹⁾	\$ (5,032)	\$ (6,286)	\$ (7,923)
Net change in fair value related to cash flow hedging activities, net of tax ⁽²⁾	(30)	(8)	66
Net reclassifications of losses to earnings, net of tax ⁽³⁾	1,003	1,262	1,571
Ending balance ⁽¹⁾	<u>\$ (4,059)</u>	<u>\$ (5,032)</u>	<u>\$ (6,286)</u>

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

(2) Net of tax (benefit) expense of \$(16) million, \$(5) million, and \$36 million for years ended December 31, 2007, 2006 and 2005, respectively.

(3) Net of tax benefit of \$540 million, \$680 million and \$846 million for years ended December 31, 2007, 2006 and 2005, respectively.

During 2006 and 2005, our hedge accounting relationships primarily consisted of hedging benchmark interest-rate risk related to the forecasted issuances of debt that were designated as cash flow hedges, and fair value hedges of benchmark interest-rate risk and/or foreign currency risk on existing fixed-rate debt. Table 11.2 summarizes certain gains (losses) and hedge ineffectiveness recognized related to our hedge accounting categories.

Table 11.2 — Hedge Accounting Categories Information

	Year Ended December 31,		
	2007	2006	2005
	(in millions)		
Fair value hedges			
Hedge ineffectiveness recognized in other income — pre-tax ⁽¹⁾	\$—	\$2	\$22
Cash flow hedges			
Hedge ineffectiveness recognized in other income — pre-tax ⁽¹⁾	—	—	—
Net pre-tax gains (losses) resulting from the determination that it was probable that forecasted transactions would not occur ⁽²⁾	—	—	(25)

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

(2) These forecasted transactions relate to the purchase or sale of mortgage loans and mortgage-related securities.

NOTE 12: LEGAL CONTINGENCIES

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

Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. Any additional losses that might result from the adverse resolution of any of the remaining legal proceedings could be greater than our current reserves.

Recent Putative Securities Class Action Lawsuits. *Reimer vs. Freddie Mac, Syron, Cook, Pizsel and McQuade and Ohio Public Employees Retirement System vs. Freddie Mac, Syron, et al.* Two virtually identical putative securities class action lawsuits were filed against Freddie Mac and certain of our current and former officers alleging that the defendants violated federal securities laws by making “false and misleading statements concerning our business, risk management and the procedures we put into place to protect the company from problems in the mortgage industry.” One suit was filed on November 21, 2007 in the US District Court for the Southern District of New York and the other was filed on January 18, 2008 in the US District Court for the Northern District of Ohio. The plaintiffs are seeking unspecified damages and interest, reasonable costs including attorneys' fees and equitable and other injunctive relief. At present, it is not possible to predict the probable outcomes of these lawsuits or any potential impact on our business, financial condition, or results of operation.

Recent Shareholder Demand Letters. In late 2007, the Board of Directors received two letters from purported shareholders of Freddie Mac alleging corporate mismanagement and breaches of fiduciary duty in connection with the company's risk management. One letter demands that the Board commence an independent investigation into the alleged conduct, institute legal proceedings to recover damages from the responsible individuals, and implement corporate governance initiatives to ensure that the alleged problems do not recur. The other letter demands that Freddie Mac

commence legal proceedings to recover damages from responsible Board members, senior officers, Freddie Mac's outside auditors, and other parties who allegedly aided or abetted the improper conduct. The Board of Directors formed a special committee to investigate the purported shareholders' allegations.

Antitrust Lawsuits. Consolidated lawsuits were filed against Fannie Mae and us in the U.S. District Court for the District of Columbia, originally filed on January 10, 2005, alleging that both companies conspired to establish and maintain artificially high guarantee fees. The complaint covers the period January 1, 2001 to the present and asserts a variety of claims under federal and state antitrust laws, as well as claims under consumer-protection and similar state laws. The plaintiffs seek injunctive relief, unspecified damages (including treble damages with respect to the antitrust claims and punitive damages with respect to some of the state claims) and other forms of relief. We filed a motion to dismiss the action and are awaiting a ruling from the court. At present, it is not possible for us to predict the probable outcome of the consolidated lawsuit or any potential impact on our business, financial condition or results of operations.

Securities Class Action Lawsuits. In June 2003 and thereafter, securities class action lawsuits were brought against us and certain former executive officers in connection with the restatement and eventually were consolidated in the U.S. District Court for the Southern District of New York. The plaintiffs claimed that the defendants improperly managed earnings to create a misleading impression of steady earnings by Freddie Mac, that they engaged in a number of improper transactions that violated GAAP and that they made false and misleading statements regarding the same. On October 26, 2006, the court approved a settlement of the securities class action lawsuits, as well as the shareholder derivative actions described below. The settlement of these actions included a cash payment of \$410 million. The settlement does not include any admission of wrongdoing by the company.

Shareholder Derivative Lawsuits. Two shareholder derivative lawsuits were filed during 2003 against certain former and current executives and, in one of the suits, certain former and current members of the board of directors and five counterparties. The plaintiffs alleged claims for breach of fiduciary duties, indemnification, waste of corporate assets, unjust enrichment and aiding and abetting breach of fiduciary duties in connection with the restatement. Both cases were ultimately assigned to the same judge in New York who handled the securities class action lawsuits described above. As described above, on October 26, 2006, the court approved a settlement of both shareholder derivative actions, as well as the securities class action lawsuits. The settlement of these cases was based in part on corporate governance reforms we instituted under our current management.

The New York Attorney General's Investigation. In connection with the New York Attorney General's suit filed against eAppraiseIT and its parent corporation, First American, alleging appraisal fraud in connection with loans originated by Washington Mutual, in November 2007, the New York Attorney General demanded that we either retain an independent examiner to investigate our mortgage purchases from Washington Mutual supported by appraisals conducted by eAppraiseIT, or immediately cease and desist from purchasing or securitizing Washington Mutual loans and any loans supported by eAppraiseIT appraisals. We also received a subpoena from the New York Attorney General's office for information regarding appraisals and property valuations as they relate to our mortgage purchases and securitizations from January 1, 2004 to the present. Currently, we are discussing with the New York Attorney General and OFHEO resolution of the matter.

Settlement of the SEC Investigation. On September 27, 2007, we reached an agreement with the SEC to settle its investigation relating to the restatement of our previously issued consolidated financial statements for 2000, 2001, and the first three quarters of 2002, and the revision of fourth quarter and full-year consolidated financial statements for 2002. Under the terms of the settlement, Freddie Mac neither admitted nor denied allegations of federal securities law violations. The settlement included a payment of \$50 million.

NOTE 13: INCOME TAXES

We are exempt from state and local income taxes. Table 13.1 presents the components of our provision for income taxes for 2007, 2006, and 2005.

Table 13.1 — Provision for Federal Income Taxes

	Year Ended December 31,		
	2007	Adjusted (in millions)	
	2006	2005	
Current income tax expense (benefit)	\$ 1,060	\$ 966	\$ 1,820
Deferred income tax expense (benefit)	(3,943)	(1,011)	(1,462)
Total income tax expense (benefit) ⁽¹⁾	<u>\$ (2,883)</u>	<u>\$ (45)</u>	<u>\$ 358</u>

(1) Does not reflect (a) the deferred tax effects of unrealized (gains) losses on available-for-sale securities, net (gains) losses related to the effective portion of derivatives designated in cash flow hedge relationships, and certain changes in our defined benefit plans which are reported as part of AOCI, (b) certain stock-based compensation tax effects reported as part of additional paid-in capital, and (c) the tax effect of cumulative effect of change in accounting principles.

A reconciliation between our federal statutory income tax rate and our effective tax rate for 2007, 2006, and 2005 is presented in Table 13.2.

Table 13.2 — Reconciliation of Statutory to Effective Tax Rate

	Year Ended December 31,					
	(Adjusted)					
	2007		2006		2005	
	Amount	Percent	Amount	Percent	Amount	Percent
	(dollars in millions)					
Statutory corporate tax rate	\$ (2,092)	35.0%	\$ 799	35.0%	\$ 885	35.0%
Tax credits	(534)	8.9	(461)	(20.2)	(365)	(14.4)
Tax-exempt interest	(255)	4.3	(255)	(11.2)	(221)	(8.7)
Unrecognized tax benefits and related interest/contingency reserves	32	(0.5)	(135)	(5.9)	49	1.9
Penalties	—	—	—	—	1	0.1
Other	(34)	0.5	7	0.3	9	0.3
Effective tax rate	<u>\$ (2,883)</u>	<u>48.2%</u>	<u>\$ (45)</u>	<u>(2.0)%</u>	<u>\$ 358</u>	<u>14.2%</u>

Our effective tax rate differs from the federal statutory tax rate of 35% primarily due to the benefits of our investments in LIHTC partnerships and tax-exempt housing-related securities. In 2006, we released \$174 million of tax reserves primarily as a result of a U.S. Tax Court decision and a separate settlement with the IRS.

The sources and tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities for the years ended December 31, 2007 and 2006 are presented in Table 13.3.

Table 13.3 — Deferred Tax Assets and (Liabilities)

	December 31,	
	2007	Adjusted 2006
	(in millions)	
Deferred tax assets:		
Deferred fees related to securitizations	\$ 3,680	\$ 2,146
Basis differences related to derivative instruments	3,477	1,698
Credit related items and reserve for loan losses	1,013	226
Employee compensation and benefit plans	196	195
Unrealized (gains) losses related to available-for-sale securities	3,791	1,794
Total deferred tax asset	<u>12,157</u>	<u>6,059</u>
Deferred tax liabilities:		
Premium and discount amortization	(1,380)	(1,320)
Basis differences related to assets held for investment	(431)	(341)
Other items, net	(42)	(52)
Total deferred tax (liability)	<u>(1,853)</u>	<u>(1,713)</u>
Net deferred tax asset/ (liability)	<u>\$10,304</u>	<u>\$ 4,346</u>

Management believes that the realization of our gross deferred tax asset of \$12 billion at December 31, 2007 is more likely than not. We are in a cumulative loss position for the three years ended December 31, 2007 due to the loss incurred in 2007. However, we believe we will generate sufficient taxable income in the future to realize these deferred tax assets. In making this determination we considered the nature of the book losses, our earnings history, forecasts of future profitability, capital adequacy, management's intent to hold investments until losses can be recovered and the duration of statutory

carryback and carryforward periods. If future events significantly differ from our current forecasts, a valuation allowance may need to be established.

As of December 31, 2007, based on estimates of taxable income, we have no tax credit carryforwards. However, management expects that our ability to use all of the tax credits generated by existing or future investments in LIHTC partnerships to reduce our federal income tax liability may be limited by the alternative minimum tax in future years.

We adopted the provisions of FIN 48 effective January 1, 2007 and as a result recorded a \$181 million increase to retained earnings. A reconciliation of the balance of unrecognized tax benefits from January 1, 2007 to December 31, 2007 is presented in Table 13.4.

Table 13.4 — Unrecognized Tax Benefits

	<u>(in millions)</u>
Balance at January 1, 2007	\$677
Increases based on tax positions prior to 2007	—
Decreases based on tax positions prior to 2007	—
Change to tax positions that only affect timing	(40)
Increases based on tax positions related to 2007	—
Balance at December 31, 2007	<u>\$637</u>

At December 31, 2007, we had total unrecognized tax benefits, exclusive of interest, of \$637 million. Included in the \$637 million are \$76 million of unrecognized tax benefits that, if recognized, would favorably affect our effective tax rate. The remaining \$561 million of unrecognized tax benefits relate to tax positions for which ultimate deductibility is highly certain, but for which there is uncertainty as to the timing of such deductibility. Recognition of these tax benefits, other than applicable interest, would not affect our effective tax rate.

We recognize interest and penalties, if any, in income tax expense. As of December 31, 2007, we had total accrued interest receivable, net of tax effect, of \$55 million. Amounts included in total accrued interest relate to: (a) unrecognized tax benefits; (b) pending claims with the IRS for open tax years; (c) the tax benefit related to tax refund claims; and (d) the impact of payments made to the IRS in prior years in anticipation of potential tax deficiencies. Of the \$55 million of accrued interest receivable as of December 31, 2007, approximately \$137 million of accrued interest payable, net of tax effect, is allocable to unrecognized tax benefits. During 2007 we recognized within tax expense \$32 million of interest expense allocable to unrecognized tax benefits. We have no amount accrued for penalties.

The statute of limitations for federal income tax purposes is open on corporate income tax returns filed for years 1985 to 2006. The IRS is currently examining tax years 2003 to 2005. The IRS has completed its examination of years 1998 to 2002. The principal matter in controversy as the result of the examination involves questions of timing and potential penalties regarding our tax accounting method for certain hedging transactions. Tax years 1985 to 1997 are before the U.S. Tax Court. We are currently in settlement discussions with the IRS regarding the tax treatment of the customer relationship intangible asset recognized upon our transition from non-taxable to taxable status in 1985. We believe it is reasonably possible that significant changes in the gross balance of unrecognized tax benefits may occur within the next 12 months that could have a material impact on income tax expense or benefit in the period the issue is resolved; however, we cannot predict the amount of such change or the range of potential changes.

NOTE 14: EMPLOYEE BENEFITS

Defined Benefit Plans

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

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

For financial reporting purposes, we use a September 30 valuation measurement date for all of our defined benefit plans. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for further information regarding the pending change to our measurement date.

We accrue the estimated cost of retiree benefits as employees render the services necessary to earn their pension and postretirement health benefits. Our pension and postretirement health care costs related to these defined benefit plans for 2007, 2006 and 2005 presented in the following tables were calculated using assumptions as of September 30, 2006, 2005 and 2004, respectively. The funded status of our defined benefit plans for 2007 and 2006 presented in the following tables was calculated using assumptions as of September 30, 2007 and 2006, respectively.

Table 14.1 shows the changes in our benefit obligations and fair value of plan assets using a September 30 valuation measurement date for amounts recognized on our consolidated balance sheets at December 31, 2007 and 2006, respectively.

Table 14.1 — Obligation and Funded Status of our Defined Benefit Plans

	Pension Benefits		Postretirement Health Benefits	
	2007	2006	2007	2006
	(in millions)			
Change in benefit obligation:				
Benefit obligation at October 1 (prior year)	\$504	\$457	\$ 121	\$ 110
Service cost	34	31	9	9
Interest cost	30	26	7	6
Net actuarial gain	(21)	(1)	(9)	(3)
Benefits paid	(8)	(9)	(1)	(1)
Benefit obligation at September 30	<u>539</u>	<u>504</u>	<u>127</u>	<u>121</u>
Change in plan assets:				
Fair value of plan assets at October 1 (prior year)	\$501	\$333		
Actual return on plan assets	65	31		
Employer contributions	1	146		
Benefits paid	(8)	(9)		
Fair value of plan assets at September 30	<u>559</u>	<u>501</u>		
Funded status at September 30	<u>\$ 20</u>	<u>\$ (3)</u>	<u>\$(127)</u>	<u>\$(121)</u>
Amounts recognized on our consolidated balance sheets at December 31:				
Other assets	\$ 77	\$ 42	\$ —	\$ —
Other liabilities	(57)	(45)	(127)	(121)
AOCI, net of taxes related to defined benefit plans:				
Net actuarial loss	\$ 37	\$ 72	\$ 8	\$ 17
Prior service cost (credit)	1	1	(2)	(3)
Total AOCI, net of taxes ⁽¹⁾	<u>\$ 38</u>	<u>\$ 73</u>	<u>\$ 6</u>	<u>\$ 14</u>

(1) These amounts represent a reduction to AOCI.

The amount included in AOCI, net of taxes, arising from a change in the minimum pension liability was a loss of \$2 million for the year ended December 31, 2006.

The accumulated benefit obligation for all defined benefit pension plans was \$393 million and \$362 million at September 30, 2007 and 2006, respectively. The accumulated benefit obligation represents the actuarial present value of future expected benefits attributed to employee service rendered before the measurement date and based on employee service and compensation prior to that date.

Table 14.2 provides additional information for our defined benefit pension plans. The aggregate accumulated benefit obligation and fair value of plan assets are disclosed as of September 30, 2007, with the projected benefit obligation included for illustrative purposes.

Table 14.2 — Additional Information for Defined Benefit Pension Plans

	2007			2006		
	Pension Plan	SERP	Total	Pension Plan	SERP	Total
	(in millions)					
Projected benefit obligation	\$482	\$ 57	\$539	\$458	\$ 46	\$504
Fair value of plan assets	\$559	\$ —	\$559	\$501	\$ —	\$501
Accumulated benefit obligation	<u>353</u>	<u>40</u>	<u>393</u>	<u>329</u>	<u>33</u>	<u>362</u>
Fair value of plan assets over (under) accumulated benefit obligation	<u>\$206</u>	<u>\$(40)</u>	<u>\$166</u>	<u>\$172</u>	<u>\$(33)</u>	<u>\$139</u>

The measurement of our benefit obligations includes assumptions about the rate of future compensation increases included in Table 14.3.

Table 14.3 — Weighted Average Assumptions Used to Determine Projected and Accumulated Benefit Obligations

	Pension Benefits		Postretirement Health Benefits	
	September 30,		September 30,	
	2007	2006	2007	2006
Discount rate	6.25%	6.00%	6.25%	6.00%
Rate of future compensation increase	5.10% to 6.50%	5.10% to 6.50%	—	—

Table 14.4 presents the components of the net periodic benefit cost with respect to pension and postretirement health care benefits for the years ended December 31, 2007, 2006 and 2005. Net periodic benefit cost is included in salaries and employee benefits on our consolidated statements of income.

Table 14.4 — Net Periodic Benefit Cost Detail

	Pension Benefits			Postretirement Health Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2007	2006	2005	2007	2006	2005
	(in millions)					
Net periodic benefit cost detail:						
Service cost	\$ 34	\$ 31	\$ 27	\$ 9	\$ 9	\$ 9
Interest cost on benefit obligation	30	26	22	7	6	6
Expected return on plan assets	(37)	(24)	(18)	—	—	—
Recognized net (gain) loss	4	6	5	1	2	3
Recognized prior service cost (credit)	—	—	1	(1)	(1)	(1)
Net periodic benefit cost	<u>\$ 31</u>	<u>\$ 39</u>	<u>\$ 37</u>	<u>\$16</u>	<u>\$16</u>	<u>\$17</u>

Table 14.5 presents the changes in AOCI, net of taxes, related to our defined benefit plans recorded to AOCI throughout the year, after the effects of our federal statutory tax rate of 35%.

Table 14.5 — AOCI, Net of Taxes, Related to Defined Benefit Plans

	Year Ended December 31, 2007 (in millions)
Beginning balance	\$(87)
Amounts recognized in AOCI, net of tax:	
Recognized net gain (loss) ⁽¹⁾	41
Net reclassification adjustments, net of tax: ⁽²⁾	
Recognized net loss (gain) ⁽³⁾	3
Recognized prior service cost (credit)	(1)
Ending balance	<u>\$(44)</u>

(1) Includes the correction of deferred taxes of \$5 million related to previously recorded Medicare Part D subsidies from prior years. Net of tax expense of \$18 million for the year ended December 31, 2007.

(2) Represent amounts subsequently recognized as adjustments to other comprehensive income as those amounts are recognized as components of net periodic benefit cost.

(3) Net of tax benefit of \$2 million for the year ended December 31, 2007.

Table 14.6 includes the assumptions used in the measurement of our net periodic benefit cost.

Table 14.6 — Weighted Average Assumptions Used to Determine Net Periodic Benefit Cost

	Pension Benefits			Postretirement Health Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2007	2006	2005	2007	2006	2005
Discount rate	6.00%	5.75%	5.75%	6.00%	5.75%	5.75%
Rate of future compensation increase	5.10% to 6.50%	5.10% to 6.50%	4.50%	—	—	—
Expected long-term rate of return on plan assets	7.50%	7.25%	7.00%	—	—	—

For the 2007 and 2006 benefit obligations, we determined the discount rate using a yield curve consisting of spot interest rates at half-year increments for each of the next 30 years, developed with pricing and yield information from high-quality bonds. The future benefit plan cash flows were then matched to the appropriate spot rates and discounted back to the measurement date. Finally, a single equivalent discount rate was calculated that, when applied to the same cash flows, results in the same present value of the cash flows as of the measurement date.

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

The assumed health care cost trend rates used in measuring the accumulated postretirement benefit obligation as of September 30, 2007 are 9% in 2008, gradually declining to an ultimate rate of 5% in 2012 and remaining at that level thereafter.

Table 14.7 sets forth the effect on the accumulated postretirement benefit obligation for health care benefits as of September 30, 2007, and the effect on the service cost and interest cost components of the net periodic postretirement health benefit cost that would result from a 1% increase or decrease in the assumed health care cost trend rate.

Table 14.7 — Selected Data Regarding our Retiree Medical Plan

	1% Increase	1% Decrease
	(in millions)	
Effect on the accumulated postretirement benefit obligation for health care benefits	\$28	\$(22)
Effect on the service and interest cost components of the net periodic postretirement health benefit cost	4	(3)

Plan Assets

Table 14.8 sets forth our Pension Plan asset allocations, based on fair value, at September 30, 2007 and 2006, and target allocation by asset category.

Table 14.8 — Pension Plan Assets by Category

Asset Category	Target Allocation	Plan Assets at September 30,	
		2007	2006
Equity securities	65.0%	66.5%	49.6%
Debt securities	35.0	33.4	25.9
Other ⁽¹⁾	—	0.1	24.5
Total	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

(1) Consists of cash contributions made on September 29, 2006, which were not fully invested by September 30th of that year.

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

Our Pension Plan assets did not include any direct ownership of our securities at September 30, 2007 and 2006.

Cash Flows Related to Defined Benefit Plans

Our general practice is to contribute to our Pension Plan an amount equal to at least the minimum required contribution, if any, but no more than the maximum amount deductible for federal income tax purposes each year. During 2007, we made no contributions to our Pension Plan. During 2006, we made two contributions totaling \$143 million to our Pension Plan. We have not yet determined whether a contribution to our Pension Plan is required for the 2008 plan year.

In addition to the Pension Plan contributions noted above, we paid \$1 million during 2007 and \$3 million during 2006 in benefits under our SERP. Allocations under our SERP, as well as our Retiree Health Plan, are in the form of benefit payments, as these plans are required to be unfunded.

Table 14.9 sets forth estimated future benefit payments expected to be paid for our defined benefit plans. The expected benefits are based on the same assumptions used to measure our benefit obligation at September 30, 2007.

Table 14.9 — Estimated Future Benefit Payments

	Pension Benefits	Postretirement Health Benefits
		(in millions)
2008	\$ 9	\$ 2
2009	12	2
2010	12	3
2011	14	3
2012	16	4
Years 2013-2017	140	27

Defined Contribution Plans

Our Thrift/401(k) Savings Plan, or Savings Plan, is a tax-qualified defined contribution pension plan offered to all eligible employees. Employees are permitted to contribute from 1% to 25% of their eligible compensation to the Savings Plan, subject to limits set by the Internal Revenue Code. We match employees' contributions up to 6% of their eligible compensation per year, with such matching contributions being made each pay period; the percentage matched depends upon the employee's length of service. Employee contributions and our matching contributions are immediately vested. We also have discretionary authority to make additional contributions to our Savings Plan that are allocated to each eligible employee, based on the employee's eligible compensation. Effective January 1, 2007, employees become vested in our discretionary contributions ratably over such employee's first five years of service, after which time employees are fully vested in their discretionary contribution accounts. In addition to our Savings Plan, we maintain a non-qualified defined contribution plan for our officers, designed to make up for benefits lost due to limitations on eligible compensation imposed by the Internal Revenue Code and to make up for deferrals of eligible compensation under our Executive Deferred Compensation Plan. We incurred costs of \$36 million, \$34 million and \$31 million for the years ended December 31, 2007, 2006 and 2005, respectively, related to these plans. These expenses were included in salaries and employee benefits on our consolidated statements of income.

Executive Deferred Compensation Plan

Our Executive Deferred Compensation Plan is an unfunded, non-qualified plan that allowed certain key employees to elect to defer substantially all or a portion of their annual salary and cash bonus, and certain key management employees to defer the settlement of restricted stock units received from us in 2007, as well as substantially all or a portion of their annual salary and cash bonus, for any number of years specified by the employee. However, under no circumstances may the period elected exceed his or her life expectancy. As of January 1, 2008, only officers are permitted to participate in the Executive Deferred Compensation Plan. Distributions are paid from our general assets. We record a liability equal to the accumulated deferred salary, cash bonus and accrued interest as set forth in the plan, net of any related distributions made to plan participants. We recognize expense equal to the interest accrued on deferred salary and bonus throughout the year. Expense associated with unvested deferred restricted stock units is recognized as part of stock-based compensation.

NOTE 15: SEGMENT REPORTING

Effective December 1, 2007, management determined that our operations consist of three reportable segments. As discussed below, we use Adjusted operating income to measure and assess the financial performance of our segments. Adjusted operating income is calculated for the segments by adjusting net income for certain investment-related activities and credit guarantee-related activities. Prior to December 1, 2007, we reported as a single segment using GAAP-basis income. We have revised the financial information and disclosures for prior periods to reflect the segment disclosures as if they had been in effect throughout all periods reported.

Segments

Our business operations include three reportable segments, which are based on the type of business activities each performs — Investments, Single-family Guarantee and Multifamily. Certain activities that are not part of a segment are included in the All Other category, which primarily includes certain unallocated corporate items, such as costs associated with remediating our internal controls and near-term restructuring costs, costs related to the resolution of certain legal matters and certain income tax items. We evaluate our performance and allocate resources based on Adjusted operating income, which we describe and present in this note. We do not consider our assets by segment when making these evaluations or allocations.

Investments

In this segment, we invest principally in mortgage-related securities and single-family mortgage loans through our mortgage-related investment portfolio. Adjusted operating income consists primarily of the returns on these investments, less the related financing costs and administrative expenses. Within this segment, our activities may include the purchase of mortgage loans and mortgage-related securities with less attractive investment returns and with incremental risk in order to achieve our affordable housing goals and subgoals. We maintain a cash and a non-mortgage-related securities investment portfolio in this segment to help manage our liquidity. We finance these activities primarily through issuances of short- and long-term debt in the public markets. Results also include derivative transactions we enter into to help manage interest-rate and other market risks associated with our debt financing and mortgage-related investment portfolio.

Single-family Guarantee

In this segment, we guarantee the payment of principal and interest on single-family mortgage-related securities, including those held in our retained portfolio, in exchange for guarantee fees received over time and other up-front

compensation. Earnings for this segment consist of guarantee fee revenues less the related credit costs (*i.e.*, provision for credit losses) and operating expenses. Also included is the interest earned on assets held in the Investments segment related to single-family guarantee activities, net of allocated funding costs and amounts related to net float benefits. Float arises from timing differences between when the borrower makes principal payments on the loan and the reduction of the PC balance.

Multifamily

In this segment, we purchase multifamily mortgages for our retained portfolio and guarantee the payment of principal and interest on multifamily mortgage-related securities and mortgages underlying multifamily housing revenue bonds. These activities support our mission to supply financing for affordable rental housing. This segment also includes certain equity investments in various limited partnerships that sponsor low- and moderate-income multifamily rental apartments, which benefit from low-income housing tax credits. Also included is the interest earned on assets held in the Investments segment related to multifamily guarantee activities, net of allocated funding costs.

All Other

All Other includes corporate-level expenses not allocated to any of our reportable segments such as costs associated with remediating our internal controls and near-term restructuring costs, and costs related to the resolution of certain legal matters and certain income tax items.

Segment Allocations

Results of each reportable segment include directly attributable revenues and expenses. Administrative expenses that are not directly attributable to a segment are allocated ratably using alternative quantifiable measures such as headcount distribution or segment usage if considered semi-direct or on a pre-determined basis if considered indirect. Expenses not allocated to segments consist primarily of costs associated with remediating our internal controls and near-term restructuring costs and are included in the All Other category. Net interest income for each segment includes an allocation related to investments and debt based on each segment's assets and off-balance sheet obligations. The LIHTC tax benefit is allocated to the Multifamily segment. All remaining taxes are calculated based on a 35% federal statutory rate as applied to Adjusted operating income.

Adjusted Operating Income

In managing our business, we present the operating performance of our segments using Adjusted operating income. Adjusted operating income differs significantly from, and should not be used as a substitute for net income (loss) before cumulative effect of change in accounting principle or net income (loss) as determined in accordance with GAAP. There are important limitations to using Adjusted operating income as a measure of our financial performance. Among other things, our regulatory capital requirements are based on our GAAP results. Adjusted operating income adjusts for the effects of certain gains and losses and mark-to-market items which, depending on market circumstances, can significantly affect, positively or negatively, our GAAP results and which, in recent periods, have caused us to record GAAP net losses. GAAP net losses will adversely impact our regulatory capital, regardless of results reflected in Adjusted operating income. Also, our definition of Adjusted operating income may differ from similar measures used by other companies. However, we believe that the presentation of Adjusted operating income highlights the results from ongoing operations and the underlying results of the segments in a manner that is useful to the way we manage and evaluate the performance of our business.

The objective of Adjusted operating income is to present our results on an accrual basis as the cash flows from our segments are earned over time. We are primarily a buy and hold investor in mortgage assets, and given our business objectives, we believe it is meaningful to measure performance of our investment business using long-term returns, not on a short-term fair value basis. The business model for our investment activity is one where we generally hold our investments for the long term, fund the investments with debt and derivatives to minimize interest rate risk, and generate net interest income in line with our return on equity objectives. The business model for our credit guarantee activity is one where we are a long-term guarantor of the conforming mortgage markets, manage credit risk, and generate guarantee and credit fees, net of incurred credit losses. As a result of these business models, we believe that an accrual-based metric is a meaningful way to present the emergence of our results as actual cash flows are realized, net of credit losses and impairments. In summary, adjusted operating results provide a view of our financial results that is more consistent with our business objectives, which helps us better evaluate the performance of our business, both from period to period and over the longer term.

As described below, Adjusted operating income is calculated for the segments by adjusting net income (loss) before cumulative effect of change in accounting principle for certain investment-related activities and credit guarantee-related activities. Adjusted operating income includes certain reclassifications among income and expense categories that have no impact on net income (loss) but provide us with a meaningful metric to assess the performance of each segment and the company as a whole.

Investment Activity-Related Adjustments

The most significant risk inherent in our investing activities is interest-rate risk, including duration, convexity and volatility. We actively manage these risks through asset selection and structuring, financing asset purchases with a broad range of both callable and non-callable debt and the use of interest-rate derivatives, designed to economically hedge a significant portion of our interest-rate exposure. Our interest-rate derivatives include interest-rate swaps, exchange-traded futures, and both purchased and written options (including swaptions). GAAP-basis earnings related to investment activities of our Investments segment, and to a lesser extent, our Multifamily segment, are subject to significant period-to-period variability, which we believe is not necessarily indicative of the risk management techniques that we employ and the performance of these segments.

Our derivative instruments are adjusted to fair value under GAAP with resulting gains or losses recorded in GAAP-basis income. Certain other assets are also adjusted to fair value under GAAP with resulting gains or losses recorded in GAAP-basis income. These assets consist primarily of mortgage-related securities classified as trading and mortgage-related securities classified as available-for-sale when a decline in fair value of available-for-sale securities is deemed to be other than temporary.

To help us assess the performance of our investment-related activities, we make the following adjustments to earnings as determined under GAAP. We believe this measure of performance, which we call Adjusted operating income, enhances the understanding of operating performance for specific periods, as well as trends in results over multiple periods, as this measure is consistent with assessing our performance against our investment objectives and the related risk-management activities.

- Derivative and foreign currency translation-related adjustments:
 - Fair value adjustments on derivative positions, recorded pursuant to GAAP, are not recognized in Adjusted operating income as these positions economically hedge our investment activities.
 - Payments or receipts to terminate derivative positions are amortized prospectively into Adjusted operating income on a straight-line basis over the associated term of the derivative instrument.
 - Payments of up-front premiums (*e.g.*, payments made to third parties related to purchased swaptions) are amortized prospectively on a straight-line basis into Adjusted operating income over the contractual life of the instrument. The up-front payments, primarily for option premiums, are amortized to reflect the periodic cost associated with the protection provided by the option contract.
 - Foreign-currency translation gains and losses associated with foreign-currency denominated debt along with the foreign currency derivatives gains and losses are excluded from Adjusted operating income because the fair value adjustments on the foreign-currency swaps that we use to manage foreign-currency exposure are also excluded through the fair value adjustment on derivative positions as described above as the foreign currency exposure is economically hedged.
- Investment sales, debt retirements and fair value-related adjustments:
 - Gains and losses on investment sales and debt retirements that are recognized at the time of the transaction pursuant to GAAP are not immediately recognized in Adjusted operating income. Gains and losses on securities sold out of the retained portfolio and cash and investments portfolio are amortized prospectively into Adjusted operating income on a straight-line basis over five years and three years, respectively. Gains and losses on debt retirements are amortized prospectively into Adjusted operating income on a straight-line basis over the original terms of the repurchased debt.
 - Trading losses or impairments that reflect expected or realized credit losses are realized immediately pursuant to GAAP and in Adjusted operating income since they are not economically hedged. Fair value adjustments to trading securities related to investments that are economically hedged are not included in Adjusted operating income. Similarly, non-credit related impairment losses on securities are not included in Adjusted operating income. These amounts are deferred and amortized prospectively into Adjusted operating income on a straight-line basis over five years for securities in the retained portfolio and over three years for securities in the cash and investments portfolio. GAAP-basis accretion income that may result from impairment adjustments is also not included in Adjusted operating income.
- Fully taxable-equivalent adjustment:
 - Interest income generated from tax-exempt investments is adjusted in Adjusted operating income to reflect its equivalent yield on a fully taxable basis.

We fund our investment assets with debt and derivatives to minimize interest-rate risk as evidenced by our PMVS and duration gap metrics. As a result, in situations where we record gains and losses on derivatives, securities or debt buybacks,

these gains and losses are offset by economic hedges that we do not mark-to-market for GAAP purposes. For example, when we realize a gain on the sale of a security, the debt which is funding the security has an embedded loss that is not recognized under GAAP, but instead over time as we realize the interest expense on the debt. As a result, in Adjusted operating income, we defer and amortize the security gain to interest income to match the interest expense on the debt that funded the asset. Because of our risk management strategies, we believe that amortizing gains or losses on economically hedged positions in the same periods as the offsetting gains or losses is a meaningful way to assess performance of our investment activities.

We believe it is useful to measure our performance using long-term returns, not on a short-term fair value basis. Fair value fluctuations in the short-term are not an accurate indication of long-term returns. In calculating Adjusted operating income, we make adjustments to our GAAP-basis results that are designed to provide a more consistent view of our financial results, which helps us better assess the performance of our business segments, both from period to period and over the longer term. The adjustments we make to present our Adjusted operating income results are consistent with the financial objectives of our investment activities and related hedging transactions and provide us with a view of expected investment returns and effectiveness of our risk management strategies that we believe is useful in managing and evaluating our investment-related activities. Although we seek to mitigate the interest-rate risk inherent in our investment-related activities, our hedging and portfolio management activities do not eliminate risk. We believe that a relevant measure of performance should closely reflect the economic impact of our risk management activities. Thus, we amortize the impact of terminated derivatives, as well as gains and losses on asset sales and debt retirements, into Adjusted operating income. Although our interest-rate risk and asset/liability management processes ordinarily involve active management of derivatives as well as asset sales and debt retirements, we believe that Adjusted operating income, although it differs significantly from, and should not be used as a substitute for GAAP-basis results, is indicative of the longer-term time horizon inherent in our investment-related activities.

Credit Guarantee Activity-Related Adjustments

Credit guarantee activities consist largely of our guarantee of the payment of principal and interest on mortgages and mortgage-related securities in exchange for guarantee and other fees. Over the longer-term, earnings consist almost entirely of the guarantee fee revenues we receive less related credit costs (*i.e.*, provision for credit losses) and operating expenses. Our measure of Adjusted operating income for these activities consists primarily of these elements of revenue and expense. We believe this measure is a relevant indicator of operating performance for specific periods, as well as trends in results over multiple periods because it more closely aligns with how we manage and evaluate the performance of the credit guarantee business.

We purchase mortgages from sellers/servicers in order to securitize and issue PCs and Structured Securities. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for a discussion of the accounting treatment of these transactions. In addition to the components of earnings noted above, GAAP-basis earnings for these activities include gains or losses upon the execution of such transactions, subsequent fair value adjustments to the guarantee asset and amortization of the guarantee obligation.

Our credit-guarantee activities also include the purchase of significantly past due mortgage loans from loan pools that underlie our guarantees. Pursuant to GAAP, at the time of our purchase, the loans are recorded at fair value. To the extent the adjustment of a purchased loan to market value exceeds our own estimate of the losses we will ultimately realize on the loan, as reflected in our loan loss reserve, an additional loss is recorded in our GAAP-basis results.

When we determine Adjusted operating income for our credit guarantee-related activities, the adjustments we apply to earnings computed on a GAAP-basis include the following:

- Amortization and valuation adjustments pertaining to the guarantee asset and guarantee obligation are excluded from Adjusted operating income. Cash compensation exchanged at the time of securitization, excluding buy-up and buy-down fees, is amortized into earnings.
- The initial recognition of gains and losses in connection with the execution of either securitization transactions that qualify as sales or guarantor swap transactions, such as losses on certain credit guarantees, is excluded from Adjusted operating income.
- Fair value adjustments recorded upon the purchase of delinquent loans from pools that underlie our guarantees are excluded from Adjusted operating income. However, for Adjusted operating income reporting, our GAAP-basis loan loss provision is adjusted to reflect our own estimate of the losses we will ultimately realize on such items.

While both GAAP-basis results and Adjusted operating income reflect a provision for credit losses determined in accordance with SFAS No. 5, GAAP-basis results also include, as noted above, measures of future cash flows (the Guarantee asset) that are recorded at fair value and, therefore, are subject to significant adjustment from period-to-period as

market conditions, such as interest rates, change. Over the longer-term, Adjusted operating income and GAAP-basis income both capture the aggregate cash flows associated with our guarantee-related activities. Although Adjusted operating income differs significantly from, and should not be used as a substitute for GAAP-basis income, we believe that excluding the impact of changes in the fair value of expected future cash flows from our Adjusted operating income provides a meaningful measure of performance for a given period as well as trends in performance over multiple periods because it more closely aligns with how we manage and evaluate the performance of the credit guarantee business.

Table 15.1 reconciles Adjusted operating income to GAAP net income (loss).

Table 15.1 — Reconciliation of Adjusted Operating Income to GAAP Net Income (Loss)

	Year Ended December 31,		
	2007	2006	2005
	(in millions)		
Adjusted operating income (loss) after taxes:			
Investments	\$ 2,028	\$ 2,111	\$ 2,284
Single-family Guarantee	(256)	1,289	965
Multifamily	398	434	363
All Other	(103)	19	(437)
Total Adjusted operating income, net of taxes	<u>2,067</u>	<u>3,853</u>	<u>3,175</u>
Reconciliation to GAAP net income (loss):			
Derivative- and foreign currency translation-related adjustments	(5,667)	(2,371)	(1,644)
Credit guarantee-related adjustments	(3,268)	(201)	(458)
Investment sales, debt retirements and fair value-related adjustments	987	231	570
Fully taxable-equivalent adjustments	(388)	(388)	(336)
Total pre-tax adjustments	<u>(8,336)</u>	<u>(2,729)</u>	<u>(1,868)</u>
Tax-related adjustments	3,175	1,203	865
Total reconciling items, net of taxes	<u>(5,161)</u>	<u>(1,526)</u>	<u>(1,003)</u>
Net income (loss) ⁽¹⁾	<u><u>\$ (3,094)</u></u>	<u><u>\$ 2,327</u></u>	<u><u>\$ 2,172</u></u>

(1) Net income (loss) reflects the impact of the adjustments described in "NOTE 20: CHANGES IN ACCOUNTING PRINCIPLES." Additionally, Net income (loss) is presented before the cumulative effect of a change in accounting principle related to 2005.

Table 15.2 presents certain financial information for our reportable segments and All Other.

Table 15.2 — Adjusted Operating Income Results and Reconciliation to GAAP Results

Year Ended December 31, 2007											
	Net Interest Income (Expense)	Management and Guarantee Income	Other Non-Interest Income (Loss)	Administrative Expenses	Provision for Credit Losses	REO Operations Expense	LIHTC Partnerships	Other Non-Interest Expense	LIHTC Partnerships Tax Benefit	Income Tax (Expense) Benefit	Net Income (Loss)
	(in millions)										
Investments	\$ 3,626	\$ —	\$ 40	\$ (515)	\$ —	\$ —	\$ —	\$ (31)	\$ —	\$(1,092)	\$ 2,028
Single-family Guarantee ..	703	2,889	117	(806)	(3,014)	(205)	—	(78)	—	138	(256)
Multifamily	426	59	24	(189)	(38)	(1)	(469)	(21)	534	73	398
All Other	(1)	—	11	(164)	—	—	—	(4)	—	55	(103)
Total Adjusted operating income (loss), net of taxes	4,754	2,948	192	(1,674)	(3,052)	(206)	(469)	(134)	534	(826)	2,067
Reconciliation to GAAP net income (loss):											
Derivative- and foreign currency translation- related adjustments ..	(1,066)	—	(4,601)	—	—	—	—	—	—	—	(5,667)
Credit guarantee-related adjustments	(106)	(342)	915	—	198	—	—	(3,933)	—	—	(3,268)
Investment sales, debt retirements and fair value-related adjustments	266	—	721	—	—	—	—	—	—	—	987
Fully taxable-equivalent adjustments	(388)	—	—	—	—	—	—	—	—	—	(388)
Reclassifications ⁽¹⁾	(361)	29	332	—	—	—	—	—	—	—	—
Tax-related adjustments	—	—	—	—	—	—	—	—	—	3,175	3,175
Total reconciling items, net of taxes	(1,655)	(313)	(2,633)	—	198	—	—	(3,933)	—	3,175	(5,161)
Total per consolidated statement of income ⁽²⁾ ..	<u>\$ 3,099</u>	<u>\$2,635</u>	<u>\$ (2,441)</u>	<u>\$(1,674)</u>	<u>\$(2,854)</u>	<u>\$(206)</u>	<u>\$(469)</u>	<u>\$(4,067)</u>	<u>\$534</u>	<u>\$ 2,349</u>	<u>\$(3,094)</u>
Year Ended December 31, 2006											
	Net Interest Income (Expense)	Management and Guarantee Income	Other Non-Interest Income (Loss)	Administrative Expenses	Provision for Credit Losses	REO Operations Expense	LIHTC Partnerships	Other Non-Interest Expense	LIHTC Partnerships Tax Benefit	Income Tax (Expense) Benefit	Net Income (Loss)
	(in millions)										
Investments	\$ 3,736	\$ —	\$ 38	\$ (495)	\$ —	\$ —	\$ —	\$ (31)	\$ —	\$(1,137)	\$ 2,111
Single-family Guarantee ..	556	2,541	159	(815)	(313)	(61)	—	(84)	—	(694)	1,289
Multifamily	479	61	28	(182)	(4)	1	(407)	(17)	461	14	434
All Other	(3)	—	15	(149)	—	—	—	(42)	—	198	19
Total Adjusted operating income (loss), net of taxes	4,768	2,602	240	(1,641)	(317)	(60)	(407)	(174)	461	(1,619)	3,853
Reconciliation to GAAP net income (loss):											
Derivative- and foreign currency translation- related adjustments ..	(1,215)	—	(1,156)	—	—	—	—	—	—	—	(2,371)
Credit guarantee-related adjustments	(12)	(172)	600	—	21	—	—	(638)	—	—	(201)
Investment sales, debt retirements and fair value-related adjustments	315	—	(84)	—	—	—	—	—	—	—	231
Fully taxable-equivalent adjustments	(388)	—	—	—	—	—	—	—	—	—	(388)
Reclassifications ⁽¹⁾	(56)	(37)	93	—	—	—	—	—	—	—	—
Tax-related adjustments	—	—	—	—	—	—	—	—	—	1,203	1,203
Total reconciling items, net of taxes	(1,356)	(209)	(547)	—	21	—	—	(638)	—	1,203	(1,526)
Total per consolidated statement of income ⁽²⁾ ..	<u>\$ 3,412</u>	<u>\$2,393</u>	<u>\$ (307)</u>	<u>\$(1,641)</u>	<u>\$(296)</u>	<u>\$(60)</u>	<u>\$(407)</u>	<u>\$(812)</u>	<u>\$461</u>	<u>\$(416)</u>	<u>\$ 2,327</u>

Year Ended December 31, 2005

	Net Interest Income (Expense)	Management and Guarantee Income	Other Non-Interest Income (Loss)	Administrative Expenses	Provision for Credit Losses	REO Operations Expense	LIHTC Partnerships	Other Non-Interest Expense	LIHTC Partnerships Tax Benefit	Income Tax (Expense) Benefit	Net Income (Loss)
	(in millions)										
Investments	\$ 4,117	\$ —	\$ (74)	\$ (466)	\$ —	\$ —	\$ —	\$ (63)	\$ —	\$(1,230)	\$ 2,284
Single-family Guarantee	349	2,341	78	(767)	(447)	(40)	—	(30)	—	(519)	965
Multifamily	417	59	19	(151)	(7)	—	(320)	(20)	365	1	363
All Other	(3)	—	(7)	(151)	—	—	—	(436)	—	160	(437)
Total Adjusted operating income (loss), net of taxes	4,880	2,400	16	(1,535)	(454)	(40)	(320)	(549)	365	(1,588)	3,175
Reconciliation to GAAP net income (loss):											
Derivative- and foreign currency translation- related adjustments	(694)	—	(950)	—	—	—	—	—	—	—	(1,644)
Credit guarantee-related adjustments	(131)	(315)	190	—	147	—	—	(349)	—	—	(458)
Investment sales, debt retirements and fair value-related adjustments	562	—	8	—	—	—	—	—	—	—	570
Fully taxable-equivalent adjustments	(336)	—	—	—	—	—	—	—	—	—	(336)
Reclassifications ⁽¹⁾	346	(9)	(337)	—	—	—	—	—	—	—	—
Tax-related adjustments	—	—	—	—	—	—	—	—	—	865	865
Total reconciling items, net of taxes	(253)	(324)	(1,089)	—	147	—	—	(349)	—	865	(1,003)
Total per consolidated statement of income ⁽²⁾	<u>\$ 4,627</u>	<u>\$2,076</u>	<u>\$(1,073)</u>	<u>\$(1,535)</u>	<u>\$(307)</u>	<u>\$(40)</u>	<u>\$(320)</u>	<u>\$(898)</u>	<u>\$365</u>	<u>\$(723)</u>	<u>\$ 2,172</u>

(1) Includes the reclassification of: a) the accrual of periodic cash settlements of all derivatives not in qualifying hedge accounting relationships from Other non-interest income (loss) to Net interest income (expense) within the Investments segment; b) implied guarantee fees on whole loans from Investments segment's Net interest income (expense) to Single-family Guarantee segment's Other non-interest income (loss); and c) net buy-up and buy-down fees from Single-family Guarantee segment's Management and guarantee income to Investments segment's Net interest income (expense).

(2) Total per consolidated statement of income reflects the impact of the adjustments described in "NOTE 20: CHANGES IN ACCOUNTING PRINCIPLES." Additionally, Net income (loss) is presented before the cumulative effect of a change in accounting principle related to 2005.

We conduct our operations solely in the United States and its territories. Therefore, we do not generate any revenue from geographic locations outside of the United States and its territories.

NOTE 16: FAIR VALUE DISCLOSURES

The supplemental consolidated fair value balance sheets in Table 16.1 present our estimates of the fair value of our recorded financial assets and liabilities and off-balance sheet financial instruments at December 31, 2007 and 2006. 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 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FASB Interpretation No. 34," (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. The valuations of financial instruments on our consolidated fair value balance sheets are in accordance with GAAP fair value guidelines prescribed by SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," and other relevant pronouncements.

Table 16.1 — Consolidated Fair Value Balance Sheets⁽¹⁾

	December 31,			
	2007		2006 (adjusted)	
	Carrying Amount ⁽²⁾	Fair Value	Carrying Amount ⁽³⁾	Fair Value
	(in billions)			
Assets				
Mortgage loans	\$ 80.0	\$ 76.8	\$ 65.6	\$ 65.4
Mortgage-related securities	629.8	629.8	634.3	634.3
Retained portfolio	709.8	706.6	699.9	699.7
Cash and cash equivalents	8.6	8.6	11.4	11.4
Investments	35.1	35.1	45.6	45.6
Securities purchased under agreements to resell and federal funds sold	6.6	6.6	23.0	23.0
Derivative assets, net	0.8	0.8	0.7	0.7
Guarantee asset ⁽³⁾	9.6	10.4	7.4	8.3
Other assets ⁽⁴⁾	23.9	31.8	16.9	14.4
Total assets	<u>\$794.4</u>	<u>\$799.9</u>	<u>\$804.9</u>	<u>\$803.1</u>
Liabilities and minority interests				
Total debt securities, net	\$738.6	\$749.3	\$744.3	\$742.7
Guarantee obligation	13.7	26.2	9.5	6.1
Derivative liabilities, net	0.6	0.6	0.2	0.2
Reserve for guarantee losses on PCs	2.6	—	0.6	—
Other liabilities	12.0	11.0	22.9	21.8
Minority interests in consolidated subsidiaries	0.2	0.2	0.5	0.5
Total liabilities and minority interests	<u>767.7</u>	<u>787.3</u>	<u>778.0</u>	<u>771.3</u>
Net assets attributable to stockholders				
Preferred stockholders	14.1	12.3	6.1	5.8
Common stockholders	12.6	0.3	20.8	26.0
Total net assets	<u>26.7</u>	<u>12.6</u>	<u>26.9</u>	<u>31.8</u>
Total liabilities, minority interests and net assets	<u>\$794.4</u>	<u>\$799.9</u>	<u>\$804.9</u>	<u>\$803.1</u>

(1) The consolidated fair value balance sheets do not purport to present our net realizable, liquidation or market value as a whole. Furthermore, amounts we ultimately realize from the disposition of assets or settlement of liabilities may vary significantly from the fair values presented.

(2) Equals the amounts reported on our GAAP consolidated balance sheets.

(3) The fair value of the guarantee asset reported exceeds the carrying value primarily because the fair value includes the guarantee asset related to PCs that were issued prior to the implementation of FIN 45 in 2003 and thus are not recognized on our GAAP consolidated balance sheets.

(4) Fair values include estimated income taxes calculated using the 35% federal statutory rate on the difference between the consolidated fair value balance sheets net assets, including deferred taxes from our GAAP consolidated balance sheets, and the GAAP consolidated balance sheets equity attributable to common stockholders.

Limitations

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

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

Valuation Methods and Assumptions

Fair value is generally based on independent price quotations obtained from third-party pricing services, dealer marks or direct market observations, where available. During the second half of 2007, the market for non-agency securities has become significantly less liquid, which has resulted in lower transaction volumes, wider credit spreads and less transparency with pricing for these assets. In addition, we have observed more variability in the quotations received from dealers and third-party pricing services. However we believe that these quotations provide reasonable estimates of fair value. If quoted

prices or market data are not available, fair value is based on internal valuation models using market data inputs or internally developed assumptions, where appropriate.

The following methods and assumptions were used to estimate the fair value of assets and liabilities at December 31, 2007 and 2006.

Mortgage Loans

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

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

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

The implied guarantee fee for both single-family and multifamily mortgage loans is also net of the related credit and other components inherent in our guarantee obligation. For single-family mortgage loans, the process for estimating the related credit and other guarantee obligation components is described in the “*Guarantee Obligation*” section. For multifamily mortgage loans, through the second quarter of 2007, the related credit and other guarantee obligation components were estimated by extracting the credit risk premium that multifamily whole loan investors require from market prices on similar securities. This credit risk premium is net of expected funding, liquidity and other risk premiums that are embedded in the market price of the reference securities. Beginning in the third quarter of 2007, the process was modified to include all related credit and other guarantee obligation components within the value of multifamily whole loans.

Mortgage-Related Securities

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

The fair value of securities with readily available third-party market prices is generally based on market prices obtained from broker/dealers or reliable third-party pricing service providers. Fair value may be estimated by using third-party quotes for similar instruments, adjusted for differences in contractual terms. For other securities, a market OAS approach based on observable market parameters is used to estimate fair value. OAS for certain securities are estimated by deriving the OAS for the most closely comparable security with an available market price, using proprietary interest-rate and prepayment models. If necessary, our judgment is applied to estimate the impact of differences in prepayment uncertainty or other unique cash flow characteristics related to that particular security. Fair values for these securities are then estimated by using the estimated OAS as an input to the interest-rate and prepayment models and estimating the net present value of the projected cash flows. The remaining instruments are priced using other modeling techniques or by using other securities as proxies.

Cash and Cash Equivalents

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

Investments

At December 31, 2007 and 2006, investments consists solely of non-mortgage-related securities, which are reported at fair value on our GAAP consolidated balance sheets. The fair values of investments were estimated using the same methods described above in “*Mortgage-Related Securities.*”

Securities Purchased Under Agreements to Resell and Federal Funds Sold

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

Derivative Assets, Net

Derivative assets largely consist of interest-rate swaps, option-based derivatives, futures and forward purchase and sale commitments that we account for as derivatives. The carrying value of our derivatives on our consolidated balance sheets is equal to their fair value, including net derivative interest receivable or payable and is net of cash collateral held or posted, where allowable by a master netting agreement. Derivatives in net unrealized gain position are reported as derivative assets, net. Similarly, derivatives in a net unrealized loss position are reported as derivative liabilities, net. As of October 1, 2007, we elected to reclassify net derivative interest receivable or payable and cash collateral held or posted on our consolidated balance sheets to derivative asset, net and derivative liability, net, as applicable. Prior to this reclassification these amounts were recorded in accounts and other receivables, net, accrued interest payable, other assets and senior debt, due within one year, as applicable. Certain amounts in prior periods' consolidated balance sheets have been reclassified to conform to the current presentation.

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

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

Guarantee Asset

At December 31, 2007 and 2006, approximately 91% and 88%, respectively, of PCs and Structured Securities issued had a corresponding guarantee asset recognized on our consolidated balance sheets. For more information regarding the accounting for the guarantee asset related to PCs and Structured Securities, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES."

For fair value balance sheet purposes, the guarantee asset is reflected for all PCs and Structured Securities and is valued using the same method as used for GAAP fair value purposes. For a description of how we determine the fair value of our guarantee asset, see "NOTE 2: FINANCIAL GUARANTEES AND TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS."

Other Assets

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

Our investments in LIHTC partnerships, reported as consolidated entities or equity method investments in the GAAP financial statements, are not within the scope of SFAS 107 disclosure requirements. However, we present the fair value of these investments in other assets. For the LIHTC partnerships, the fair value of expected tax benefits is estimated using expected cash flows discounted at a market-based yield.

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

For the credit enhancements on manufactured housing asset-backed securities, the fair value is based on the difference between the market price of non-credit-impaired manufactured housing securities and credit-impaired manufactured

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

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

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

Total Debt Securities, Net

Total debt securities, net represents short-term and long-term debt used to finance our assets and, on our consolidated GAAP balance sheets, debt securities are reported at amortized cost, which is net of deferred items, including premiums, discounts and hedging-related basis adjustments. This item includes both non-callable and callable debt as well as short-term zero-coupon discount notes. The fair value of the short-term zero-coupon discount notes is based on a discounted cash flow model with market inputs. The valuation of other debt securities is generally based on market prices obtained from broker/dealers, reliable third-party pricing service providers or direct market observations.

Guarantee Obligation

We did not establish a guarantee obligation for GAAP purposes for PCs and Structured Securities that were issued through our Guarantor Swap program prior to adoption of FIN 45. In addition, after it is initially recorded at fair value the guarantee obligation is not subsequently carried at fair value for GAAP purposes. On our consolidated fair value balance sheets, the guarantee obligation reflects the fair value of our guarantee obligation on all PCs. Additionally, for fair value balance sheet purposes, the guarantee obligation is valued using the same method as used for GAAP to determine its initial fair value. Because guarantee asset, guarantee obligation and credit enhancement-related assets that are recognized at the inception of an executed Guarantor Swap are valued independently of each other, net differences between these recognized assets and liabilities may exist at inception. If the amount of the guarantee asset plus the credit enhancement-related assets is greater than the amount of the guarantee obligation, the difference between such amounts is deferred on our GAAP consolidated balance sheets as a component of the guarantee obligation. This component of the guarantee obligation is not recorded on the consolidated fair value balance sheets. The difference between the fair value and carrying value of the guarantee obligation shown in Table 16.1 reflects the different basis of accounting for this liability. For example, the fair value of the guarantee obligation does not include the unamortized balance of deferred guarantee income that is a component of its carrying value on the GAAP consolidated balance sheets. For information concerning our valuation approach and accounting policies related to our guarantees of mortgage assets, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES,” and “NOTE 2: FINANCIAL GUARANTEES AND TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS.”

Derivative Liabilities, Net

See discussion under “*Derivative Assets, Net*” above.

Reserve For Guarantee Losses on PCs

The carrying amount of the reserve for guarantee losses on PCs on our GAAP consolidated balance sheets represents the contingent losses contained in the loans that back our PCs. This line item has no basis on our consolidated fair value balance sheets, because the estimated fair value of all expected default losses (both contingent and non-contingent) is included in the guarantee obligation reported on our consolidated fair value balance sheets.

Other Liabilities

Other liabilities principally consists of amounts due to PC investors (*i.e.*, principal and interest), funding liabilities associated with investments in LIHTC partnerships, accrued interest payable on debt securities and other miscellaneous obligations of less than one year. We believe the carrying amount of these liabilities is a reasonable approximation of their

fair value, except for funding liabilities associated with investments in LIHTC partnerships, for which fair value is estimated using expected cash flows discounted at a market-based yield. Furthermore, certain deferred items reported as other liabilities on our GAAP consolidated balance sheets are assigned zero value on our consolidated fair value balance sheets, such as deferred credit fees. Also, as discussed in “*Other Assets*,” other liabilities may include a deferred tax liability adjusted for fair value balance sheet purposes.

In addition, effective December 2007, we established securitization trusts for the assets underlying our PCs and Structured Securities. Consequently, we hold remittances in a segregated account and administer payments due to the PC investors. Other liabilities at December 31, 2007 does not reflect amounts due to PC investors since this is a liability of the off-balance sheet trusts.

Minority Interests in Consolidated Subsidiaries

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

Net Assets Attributable to Preferred Stockholders

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

Net Assets Attributable to Common Stockholders

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

NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS

Mortgages and Mortgage-Related Securities

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

- \$1.3 billion and \$1.5 billion of mortgage-related securities issued by Ginnie Mae that back Structured Securities at December 31, 2007 and 2006, respectively, because these securities do not expose us to meaningful amounts of credit risk;
- \$47.8 billion and \$45.4 billion of other agency mortgage-related securities at December 31, 2007 and 2006, respectively, because these securities do not expose us to meaningful amounts of credit risk; and
- \$233.8 billion and \$238.5 billion of non-agency mortgage-related securities held in the retained portfolio at December 31, 2007 and 2006, respectively, because geographic information regarding these securities is not available. With respect to these securities, we look to third party credit enhancements (*e.g.*, bond insurance) or other credit enhancements resulting from the securitization structure supporting such securities (*e.g.*, subordination levels) as a primary means of managing credit risk.

See “NOTE 4: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO” and “NOTE 5: MORTGAGE LOANS AND LOAN LOSS RESERVES” for more information about the securities and loans, respectively, we hold on our consolidated balance sheets.

Table 17.1 — Concentration of Credit Risk

	December 31,			
	2007		2006	
	Amount ⁽¹⁾⁽²⁾	Percentage	Amount ⁽¹⁾⁽²⁾	Percentage
	(dollars in millions)			
By Region⁽³⁾				
West	\$ 455,051	25%	\$ 366,492	24%
Northeast	443,813	24	375,844	24
North Central	353,522	19	324,255	21
Southeast	335,386	19	279,984	18
Southwest	231,951	13	194,785	13
	<u>\$1,819,723</u>	<u>100%</u>	<u>\$1,541,360</u>	<u>100%</u>
By State				
California	\$ 243,225	13%	\$ 195,964	13%
Florida	124,092	7	101,901	7
Illinois	91,835	5	80,130	5
Texas	91,130	5	74,764	5
New York	90,686	5	77,614	5
All others	1,178,755	65	1,010,987	65
	<u>\$1,819,723</u>	<u>100%</u>	<u>\$1,541,360</u>	<u>100%</u>

(1) Calculated as total mortgage portfolio less Structured Securities backed by Ginnie Mae Certificates and non-Freddie Mac mortgage-related securities held in the retained portfolio.

(2) Effective December 2007, we established securitization trusts for the underlying assets of our guaranteed PCs and Structured Securities issued. As a result, we adjusted the reported balance of our mortgage portfolios to reflect the publicly-available security balances of guaranteed PCs and Structured Securities. Previously we reported these balances based on the unpaid principal balance of the underlying mortgage loans. The trust holds remittances from loans underlying our securities in a segregated account. Consequently, we no longer commingle those funds with our general operating funds.

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

Higher-Risk Mortgage Loans

There have been an increasing amount of residential loan products originated in the mortgage industry that are designed to offer borrowers greater choices in their payment terms. Interest-only mortgages allow the borrower to pay only interest for a fixed period of time before the loan begins to amortize. Option ARM loans permit a variety of repayment options, which include minimum, interest only, fully amortizing 30-year and fully amortizing 15-year payments. The minimum payment alternative for option ARM loans allows the borrower to make monthly payments that are less than the interest accrued for the period. The unpaid interest, known as negative amortization, is added to the principal balance of the loan, which increases the outstanding loan balance. At December 31, 2007 and 2006, interest-only and option ARM loans collectively represented approximately 10% and 7%, respectively, of loans underlying our issued guaranteed PCs and Structured Securities.

In addition to these products, there has been an increase of residential mortgage loans originated in the market with lower or alternative documentation requirements than full documentation mortgage loans. These reduced documentation mortgages have been categorized in the mortgage industry as Alt-A loans. We have classified mortgage loans as Alt-A if the lender that delivers them to us has classified the loans as Alt-A, or if the loans had reduced documentation requirements that indicate that the loans should be classified as Alt-A. As of December 31, 2007, approximately 9% of our single-family PCs and Structured Securities were backed by Alt-A mortgage loans.

A combination of certain loan characteristics with any mortgage loan product often can indicate a higher degree of credit risk. For example, mortgages with both high loan-to-value, or LTV ratios and borrowers who have lower credit scores typically experience higher rates of delinquency, default and credit losses. As of December 31, 2007, approximately 1% of single-family mortgage loans we have guaranteed were made to borrowers with credit scores below 620 and had original LTV ratios above 90% at the time of mortgage origination. In addition, as of December 31, 2007, 4% of the Alt-A and interest-only single-family loans we have guaranteed have been made to borrowers with credit scores below 620 at mortgage origination. As home prices increased during 2006 and prior years, many borrowers used second liens at the time of purchase to potentially reduce their LTV ratio to below 80%. Including this secondary financing, we estimate that the percentage of loans we have guaranteed with total LTV ratios above 90% was 14% as of December 31, 2007.

Mortgage Lenders and Insurers

A significant portion of our single-family mortgage purchase volume is generated from several key mortgage lenders that have entered into business arrangements with us. These arrangements generally involve a lender's commitment to sell a high proportion of its conforming mortgage origination volume to us. Our largest mortgage lender in 2007 reduced its minimum mortgage volume commitment to us upon renewal of its contract at July 1, 2007. In addition, ABN Amro Mortgage Group, Inc., which accounted for more than 8% of our mortgage purchase volume for the six months ended June 30, 2007, was

acquired and its contract was not renewed when it expired in the third quarter 2007. During 2007, three mortgage lenders each accounted for 12% or more of our mortgage purchase volume. These lenders collectively accounted for approximately 45% of this volume. In addition, in 2007, our top ten single-family lenders represented approximately 79% of our single-family mortgage purchase volume. In 2007, our top three multifamily lenders collectively represented approximately 44% of our multifamily purchase volume and top ten multifamily lenders represented approximately 80% of our multifamily purchase volume. These top lenders are among the largest mortgage loan originators in the U.S. We are exposed to the risk that we could lose purchase volume to the extent these arrangements are terminated or modified without replacement from other lenders.

We have institutional credit risk relating to the potential insolvency or non-performance of mortgage insurers that insure mortgages we purchase or guarantee. Excluding insurers of our non-agency mortgage-related securities portfolio at December 31, 2007, our top four mortgage insurers, each accounted for more than 10% of our overall mortgage insurance coverage, collectively represented approximately 75% of our overall mortgage insurance coverage.

Bond insurers

For certain non-agency securities in both our retained and investment portfolios, we rely on subordination and bond insurance of the trust issuing the security as credit enhancement to provide protection from credit loss. In those instances where we seek further protection, we may obtain additional credit enhancement with secondary bond insurance; however this increases our exposure to the risks related to the bond insurer's ability to satisfy claims. As of December 31, 2007, we had insurance coverage, including secondary policies, on securities totaling \$17.9 billion of unpaid principal balance, consisting of \$16.1 billion and \$1.8 billion, of coverage for bonds in our retained and investment portfolio, respectively. As of December 31, 2007, the top three of our bond insurers, each accounting for more than 20% of our overall bond insurance coverage (including secondary policies), collectively represented approximately 80% of our bond insurance coverage.

Derivative Portfolio

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

Derivative Counterparties

Our use of derivatives exposes us to counterparty credit risk, which arises from the possibility that the derivative counterparty will not be able to meet its contractual obligations. Exchange-traded derivatives, such as futures contracts, do not measurably increase our counterparty credit risk because changes in the value of open exchange-traded contracts are settled daily through a financial clearinghouse established by each exchange. Over-the-counter, or OTC, derivatives, however, expose us to counterparty credit risk because transactions are executed and settled between us and our counterparty. Our use of OTC interest-rate swaps, option-based derivatives and foreign-currency swaps is subject to rigorous internal credit and legal reviews. Our derivative counterparties carry external credit ratings among the highest available from major rating agencies. All of these counterparties are major financial institutions and are experienced participants in the OTC derivatives market.

Master Netting and Collateral Agreements

We use master netting and collateral agreements to reduce our credit risk exposure to our active OTC derivative counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps. Master netting agreements provide for the netting of amounts receivable and payable from an individual counterparty, which reduces our exposure to a single counterparty in the event of default. On a daily basis, the market value of each counterparty's derivatives outstanding is calculated to determine the amount of our net credit exposure, which is equal to derivatives in a net gain position by counterparty after giving consideration to collateral posted. Our collateral agreements require most counterparties to post collateral for the amount of our net exposure to them above the applicable threshold. Bilateral collateral agreements are in place for the majority of our counterparties. Collateral posting thresholds are tied to a counterparty's credit rating. Derivative exposures and collateral amounts are monitored on a daily basis using both internal pricing models and dealer price quotes. Collateral is typically transferred within one business day based on the values of the related derivatives. This time lag in posting collateral can affect our net uncollateralized exposure to derivative counterparties.

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

Our uncollateralized exposure to counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, after applying netting agreements and collateral, was \$339 million and \$672 million at December 31, 2007 and 2006, respectively. In the event that all of our counterparties for these derivatives were to have defaulted simultaneously on December 31, 2007, our maximum loss for accounting purposes would have been approximately \$339 million.

Our exposure to counterparties for OTC forward purchase and sale commitments treated as derivatives was \$465 million and \$18 million at December 31, 2007 and 2006, respectively. Because the typical maturity for our OTC commitments is less than one year, we do not require master netting and collateral agreements for the counterparties of these commitments. Therefore, the exposure to our OTC commitments counterparties is uncollateralized. Similar to counterparties for our OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, we monitor the credit fundamentals of our OTC commitments counterparties on an ongoing basis to ensure that they continue to meet our internal risk-management standards.

NOTE 18: MINORITY INTERESTS

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

In February 1997, we formed two majority-owned REIT subsidiaries funded through the issuance of common stock (99.9% of which is held by us) and a total of \$4.0 billion of perpetual, step-down preferred stock issued to outside investors. Beginning in 2007, the dividend rate on the step-down preferred stock was 1.0%. The dividend rate on the step-down preferred stock was 13.3% from initial issuance through December 2006 (the initial term). Dividends on this preferred stock accrue in arrears. The balance of the two step-down preferred stock issuances as recorded within Minority interests in consolidated subsidiaries on our consolidated balance sheets totaled \$167 million and \$503 million at December 31, 2007 and 2006, respectively. The preferred stock continues to be redeemable by the REITs under certain circumstances described in the preferred stock offering documents as a “tax event redemption.”

NOTE 19: EARNINGS PER SHARE

We have participating securities related to options with dividend equivalent rights that receive dividends as declared on an equal basis with common shares. Consequently, in accordance with Emerging Issues Task Force, or EITF, No. 03-6, “*Participating Securities and the Two-Class Method under FASB Statement No. 128*”, we use the “two-class” method of computing earnings per share. Participating security option holders are not obligated to participate in undistributed net losses. Basic earnings per common share are computed by dividing net income (loss) available per common share by weighted average common shares outstanding — basic for the period. Diluted earnings (loss) per common share are computed as net income (loss) available to common stockholders divided by weighted average common shares outstanding — diluted for the period, which consider the effect of dilutive common equivalent shares outstanding. For periods with net income the effect of dilutive common equivalent shares outstanding includes: (a) the weighted average shares related to stock options (including the Employee Stock Purchase Plan) that have an exercise price lower than the average market price during the period; (b) the weighted average of non-vested restricted shares; and (c) all restricted stock units. Such items are excluded from the weighted average common shares outstanding — basic.

Table 19.1 — Earnings (Loss) Per Common Share — Basic and Diluted

	Year Ended December 31,		
	2007	Adjusted	
		2006	2005
	(dollars in millions, except per share amounts)		
Net income (loss)	\$ (3,094)	\$ 2,327	\$ 2,113
Preferred stock dividends and issuance costs on redeemed preferred stock	(404)	(270)	(223)
Amounts allocated to participating security option holders ⁽¹⁾	(5)	(6)	—
Net income (loss) available to common shareholders — basic ⁽²⁾	<u>\$ (3,503)</u>	<u>\$ 2,051</u>	<u>\$ 1,890</u>
Weighted average common shares outstanding — basic (in thousands)	651,881	680,856	691,582
Dilutive potential common shares (in thousands)	—	1,808	1,929
Weighted average common shares outstanding — diluted (in thousands)	<u>651,881</u>	<u>682,664</u>	<u>693,511</u>
Antidilutive potential common shares excluded from the computation of dilutive potential common shares (in thousands)	6,161	1,892	2,297
Basic earnings (loss) per common share	\$ (5.37)	\$ 3.01	\$ 2.73
Diluted earnings (loss) per common share	\$ (5.37)	\$ 3.00	\$ 2.73

(1) Participating security option holders do not participate in undistributed earnings during periods of net losses.

(2) Includes distributed and undistributed earnings to common shareholders.

NOTE 20: CHANGES IN ACCOUNTING PRINCIPLES

Effective December 31, 2007, we retrospectively changed our method of accounting for our guarantee obligation: 1) to a policy of no longer extinguishing our guarantee obligation when we purchase all or a portion of a guaranteed PC and Structured Security, or PC, from a policy of effective extinguishment through the recognition of a Participation Certificate residual, or PC residual, and 2) to a policy that amortizes our guarantee obligation into earnings in a manner that corresponds more closely to our economic release from risk under our guarantee than our former policy, which amortized our guarantee obligation according to the contractual expiration of our guarantee as observed by the decline in the unpaid principal balance of securitized mortgage loans. While our previous accounting is acceptable, we believe the newly adopted method of accounting for our guarantee obligation is preferable in that it significantly enhances the transparency and understandability of our financial results, promotes uniformity in the accounting model for the credit risk retained in our primary credit guarantee business, better aligns revenue recognition to the release from economic risk of loss under our guarantee, and increases comparability with other similar financial institutions. Comparative financial statements of prior periods have been adjusted to apply the new methods, retrospectively. Summarized impacts of the changes in accounting principles are as follows:

Table 20.1 — Net Income (Expense) Impact of Changes in Accounting Principles

	2007	2006	2005
	(in millions)		
Changes in accounting principles:			
Guarantee obligation no longer extinguished when a PC is purchased	\$ 2,289	\$(461)	\$(545)
Guarantee obligation amortization methodology	922	640	519
Total pre-tax impact of changes in accounting principles	3,211	179	(26)
Tax impact of changes in accounting principles	(1,124)	(63)	9
Total net income impact of changes in accounting principles	\$ 2,087	\$ 116	\$ (17)

Changes in Accounting Principles

Guarantee Obligation No Longer Extinguished When PC is Purchased

The change to no longer extinguish our guarantee obligation when we purchase all or a portion of a PC reflects changes made to our PC issuance process, including introducing the use of securitization trusts that are qualifying special purpose entities, or QSPE, upon PC issuance. When we subsequently purchase a PC, our guarantee obligation remains outstanding to the QSPE, an unconsolidated entity, and consequently our guarantee obligations remain outstanding. The guarantee asset also continues to remain outstanding. Application of a model that does not extinguish our guarantee asset and guarantee liability is consistent with predominant industry practice for similar transactions. Under this new model, PCs held by us are accounted for as guaranteed securities; accordingly, credit losses are recognized on an incurred basis in the provision for credit losses rather than through the recognition of a PC residual at fair value with changes in earnings or through security impairments.

We applied the change to no longer extinguish our guarantee obligation retrospectively in accordance with SFAS 154, “Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3,” or SFAS 154. This presentation significantly enhances the transparency and understandability of our financial statements in that our guarantee obligation is presented as a separate liability relative to all PCs outstanding (whether held by third parties or us). Consequently, all credit losses, except for initial losses on loans purchased as impaired loans under SOP 03-3, stemming from guarantee-related activities are now accounted for in our provision for credit losses using a single measurement attribute (*i.e.*, an incurred loss model). Gains and losses related to our previous extinguishment model have been eliminated. As such, the results of our guarantee business are less difficult to compare to other financial guarantors.

Our previous accounting method resulted in a mixed model with a portion of our guarantee obligation recorded at fair value through earnings when we held PCs, and a portion of the guarantee obligation carried at historical cost subject to credit losses recognized for probable incurred losses when the PCs were held by third parties. Under the previous model, we reflected PCs held by us as unguaranteed securities. Accordingly, these securities were subject to security impairments and the guarantee fees received reflected additional interest income.

Guarantee Obligation Amortization Method

The change in the method of amortizing our guarantee obligation into earnings uses a static effective yield calculated and fixed at inception of the guarantee based on forecasted unpaid principal balances. The static effective yield will be evaluated and adjusted when significant changes in economic events cause a shift in the pattern of our economic release from risk. For example, certain market environments may lead to sharp and sustained changes in home prices or prepayments of mortgages, leading to the need for an adjustment in the static effective yield for specific mortgage pools underlying the guarantee. When a change is required, a cumulative catch-up adjustment, which could be significant in a

given period, will be recognized and a new static effective yield will be used to determine our guarantee obligation amortization. The new method amortizes our guarantee obligation into earnings commensurate with our economic release from risk under changing economic conditions and is more consistent with our competitors than the prior amortization method. The new method has been retrospectively applied to all prior periods.

The previous method amortized our guarantee obligation according to the contractual expiration of the guarantee as observed by the decline in the unpaid principal balance of securitized mortgage loans. The previous method amortized our guarantee obligation in a manner that was reflective of the pattern of economic release from risk in periods of normal or high prepayments and normal or high house price appreciation. However, the new amortization method more closely aligns our guarantee obligation amortization with our economic release from risk, particularly in periods of slowing prepayments and slowing house price appreciation (or house price depreciation in some areas) such as experienced during the fourth quarter of 2007.

Financial Statement Impacts of the Accounting Changes

Retrospective adoption of the accounting changes impacted several financial statement line items. Because our guarantee asset and guarantee obligation remain outstanding whether held by us or third parties, line item impacts include: 1) reduced gains (losses) on investment activity resulting from the removal of PC residual fair value changes, 2) increased gains (losses) on guarantee asset relating to PCs held by us that were previously recognized as part of PC residual, 3) increased income on guarantee obligation reflecting both a change in our guarantee obligation balance resulting from no longer extinguishing our guarantee obligation and a change in our amortization policy for the guarantee obligation to one that recognizes revenue in a manner that corresponds more closely to our economic release from risk under the guarantee, 4) increased management and guarantee income and reduced interest income resulting from the reclassification of guarantee and delivery fees on PCs held by us previously recognized as interest income when our guarantee was considered extinguished, 5) increased provision for credit losses relating to additional PCs subject to our loan loss reserve model, 6) increased losses on loans purchased relating to PCs held by us that were previously recognized as part of PC residual, 7) reduced gains (losses) on investment activity resulting from the removal of adjustments to the carrying value of our securities that were previously recognized upon purchase related to the extinguishment of deferred income items and 8) reduced gains (losses) on investment activity resulting from elimination of impairments on PCs held by us that are now subject to a guarantee.

With respect to 3) above, it is important to note that the accounting change from the previous model results in an increase in our guarantee obligation balance for PCs held by us and a decrease in our guarantee obligation balance because our guarantee obligation is not re-measured at fair value when PCs previously purchased by us are subsequently sold. As such, the change in the income on guarantee obligation line item is not distinguished between no longer extinguishing our guarantee obligation and our guarantee obligation amortization change, as doing so is not operationally feasible given activity levels in the various periods presented. This difficulty highlights the fact that the change will provide financial statement users with improved transparency of operating results under the new method, in that it presents results using a single model.

Other Changes in Accounting Principles

On October 1, 2007, we adopted FSP FIN 39-1 which permits a reporting entity to offset fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting agreement. We elected to reclassify net derivative interest receivable or payable and cash collateral held or posted, on our consolidated balance sheets, to derivative asset, net and derivative liability, net, as applicable. Prior to reclassification, these amounts were recorded on our consolidated balance sheets in accounts and other receivables, net, accrued interest payable, other assets and senior debt, due within one year, as applicable. The change resulted in a decrease to total assets and total liabilities of \$8.7 billion at the date of adoption, October 1, 2007, and \$7.2 billion at December 31, 2007. The adoption of FSP FIN 39-1 had no effect on our consolidated statements of income.

On January 1, 2007, we adopted FIN 48, and as a result of adoption, we recorded a \$181 million increase to retained earnings at January 1, 2007. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information.

At December 31, 2006, we adopted SFAS 158 which requires the recognition of our pension and other postretirement plans' overfunded or underfunded status in the statement of financial position beginning December 31, 2006. As a result of the adoption, we recorded the funded status of each of our defined benefit plans as an asset or liability on our consolidated balance sheet with a corresponding offset, net of taxes, recorded in AOCI within stockholders' equity, resulting in an after-tax decrease in equity of \$84 million at December 31, 2006.

Effective January 1, 2006, we made a change to our method of amortization for certain types of non-agency securities resulting in a \$13 million (after-tax) reduction to the opening balance of retained earnings.

Beginning October 1, 2005, we changed our method for determining gains and losses upon the resale of PCs related to deferred items recognized in connection with our guarantee of those securities. This change in accounting principle was facilitated by system changes that now allow us to apply and track these deferred items relative to the specific portions of the purchased PCs. The lack of certain historical data precluded us from calculating the cumulative effect of the change. We were not able to determine the pro forma effects of applying the new method retrospectively.

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

Tax Adjustments

As a result of the changes in accounting principles, our cumulative income tax expense increased by \$0.7 billion resulting in a deferred tax asset decrease of \$0.7 billion at December 31, 2007. In addition, due to the changes in accounting principles, our deferred tax asset related to our AOCI increased by \$0.1 billion.

Table 20.2 summarizes the effect of the changes in accounting principles related to our guarantee obligation on the consolidated statements of income line items for 2007, 2006 and 2005.

Table 20.2 — Effect of Changes in Accounting Principles to Consolidated Statements of Income

	Year Ended December 31,								
	2007			2006			2005		
	As computed without changes in accounting principles	As reported with changes in accounting principles	Effect of Changes	As Previously Reported	As Adjusted	Effect of Changes	As Previously Reported	As Adjusted	Effect of Changes
	(in millions, except per share amounts)								
Interest income:									
Mortgage loans	\$ 4,446	\$ 4,449	\$ 3	\$ 4,152	\$ 4,152	\$ —	\$ 4,037	\$ 4,010	\$ (27)
Mortgage-related securities	35,707	34,893	(814)	34,673	33,850	(823)	29,684	28,968	(716)
Management and guarantee income	2,010	2,635	625	1,672	2,393	721	1,450	2,076	626
Gains (losses) on guarantee asset	(1,212)	(1,484)	(272)	(800)	(978)	(178)	(1,064)	(1,409)	(345)
Income on guarantee obligation	985	1,905	920	867	1,519	652	920	1,428	508
Derivative gains (losses)	(1,906)	(1,904)	2	(1,164)	(1,173)	(9)	(1,357)	(1,321)	36
Gains (losses) on investment activity	(3,310)	294	3,604	(474)	(473)	1	(127)	(97)	30
Recoveries on loans impaired upon purchase	438	505	67	—	—	—	—	—	—
Other income ⁽¹⁾	246	246	—	252	236	(16)	177	126	(51)
Provision for credit losses	(2,371)	(2,854)	(483)	(215)	(296)	(81)	(251)	(307)	(56)
Losses on certain credit guarantees ⁽¹⁾	(1,992)	(1,988)	4	(350)	(406)	(56)	(234)	(272)	(38)
Losses on loans purchased ⁽¹⁾	(1,419)	(1,865)	(446)	(126)	(148)	(22)	—	—	—
Other expenses	(223)	(222)	1	(190)	(200)	(10)	(537)	(530)	7
Income tax (expense) benefit	4,007	2,883	(1,124)	108	45	(63)	(367)	(358)	9
Net income (loss)	(5,181)	(3,094)	2,087	2,211	2,327	116	2,130	2,113	(17)
Basic earnings (loss) per common share	(8.58)	(5.37)	3.21	2.84	3.01	0.17	2.76	2.73	(0.03)
Diluted earnings (loss) per common share	(8.58)	(5.37)	3.21	2.84	3.00	0.16	2.75	2.73	(0.02)

(1) Hedge accounting gains previously reported separately are included in other income. Foreign-currency gains (losses), net is excluded from Other income to conform to current period presentation. Similarly, losses on certain credit guarantees and losses on loans purchased are presented separately to conform to current period presentation.

Table 20.3 summarizes the effect of the changes in accounting principles related to our guarantee obligation and adoption of FSP FIN 39-1 on the consolidated balance sheet line items as of December 31, 2007 and 2006.

Table 20.3 — Effect of Changes in Accounting Principles to Consolidated Balance Sheets

	December 31,					
	2007			2006		
	As computed without changes in accounting principles	As reported with changes in accounting principles	Effect of Changes	As Previously Reported	As Adjusted	Effect of Changes
	(in millions)					
Assets:						
Mortgage loans, net	\$ 80,167	\$ 80,032	\$ (135)	\$ 65,618	\$ 65,605	\$ (13)
Total mortgage-related securities	626,427	629,754	3,327	634,925	634,328	(597)
Accounts and other receivables, net	6,953	5,003	(1,950)	7,461	5,073	(2,388)
Derivative assets, net	5,760	827	(4,933)	7,908	665	(7,243)
Guarantee asset, at fair value	8,056	9,591	1,535	6,070	7,389	1,319
Deferred tax asset	10,903	10,304	(599)	3,600	4,346	746
Other assets	7,270	6,884	(386)	6,783	6,788	5
Total assets	797,509	794,368	(3,141)	813,081	804,910	(8,171)
Liabilities:						
Total debt securities, net	745,105	738,557	(6,548)	753,938	744,341	(9,597)
Accrued interest payable	8,132	7,864	(268)	8,345	8,307	(38)
Guarantee obligation	11,565	13,712	2,147	7,117	9,482	2,365
Derivative liabilities, net	975	582	(393)	179	165	(14)
Reserve for guarantee losses on Participation Certificates	2,001	2,566	565	350	550	200
Other liabilities	3,942	4,187	245	3,212	3,512	300
Total liabilities	771,720	767,468	(4,252)	784,264	777,480	(6,784)
Stockholders' Equity:						
Retained earnings	25,627	26,909	1,282	32,177	31,372	(805)
AOCI, net of taxes	(10,972)	(11,143)	(171)	(7,869)	(8,451)	(582)
Total stockholders' equity	25,613	26,724	1,111	28,301	26,914	(1,387)

Table 20.4 summarizes the effect of the changes in accounting principles related to our guarantee obligation on the effected consolidated statements of stockholders' equity line items for 2007, 2006 and 2005.

Table 20.4 — Effect of Changes in Accounting Principles to Consolidated Statements of Stockholders' Equity

	Year Ended December 31,								
	2007			2006			2005		
	As computed without changes in accounting principles	As reported with changes in accounting principles	Effect of Changes	As Previously Reported	As Adjusted	Effect of Changes	As Previously Reported	As Adjusted	Effect of Changes
	(in millions)								
Retained earnings:									
Balance, beginning of year	\$ 32,177	\$ 31,372	\$ (805)	\$31,559	\$30,638	\$(921)	\$30,728	\$29,824	\$(904)
Net income (loss)	(5,181)	(3,094)	2,087	2,211	2,327	116	2,130	2,113	(17)
Retained earnings, end of year	25,627	26,909	1,282	32,177	31,372	(805)	31,559	30,638	(921)
AOCI, net of taxes:									
Balance, beginning of year	(7,869)	(8,451)	(582)	(8,773)	(9,352)	(579)	(3,593)	(4,180)	(587)
Changes in unrealized gains (losses) related to available-for-sale securities, net of reclassification adjustments	(4,108)	(3,708)	400	(264)	(267)	(3)	(6,824)	(6,816)	8
Changes in unrealized gains (losses) related to cash flow hedge relationships, net of reclassification adjustments	962	973	11	1,254	1,254	—	1,637	1,637	—
AOCI, net of taxes, end of year	(10,972)	(11,143)	(171)	(7,869)	(8,451)	(582)	(8,773)	(9,352)	(579)

Table 20.5 summarizes the effect of the changes in accounting principles related to our guarantee obligation and adoption of FSP FIN 39-1 on the consolidated statement of cash flow line items for 2007, 2006, and 2005.

Table 20.5 — Effect of Changes in Accounting Principles to Consolidated Statements of Cash Flows

	Year Ended December 31,								
	2007			2006			2005		
	As computed without changes in accounting principles	As reported with changes in accounting principles ⁽¹⁾	Effect of Changes	As Previously Reported	As Adjusted ⁽¹⁾	Effect of Changes	As Previously Reported	As Adjusted ⁽¹⁾	Effect of Changes
	(in millions)								
Cash flows from operating activities									
Net Income (loss)	\$ (5,181)	\$ (3,094)	\$ 2,087	\$ 2,211	\$ 2,327	\$ 116	\$ 2,130	\$ 2,113	\$ (17)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:									
Derivative losses	2,280	2,275	(5)	1,253	1,262	9	1,014	977	(37)
Asset related amortization	(263)	(91)	172	26	128	102	791	881	90
Provision for credit losses	2,371	2,854	483	215	296	81	260	311	51
Losses on loans purchased	1,419	1,865	446	126	148	22	—	—	—
Gains (losses) on investment activity	509	(305)	(814)	494	538	44	343	267	(76)
Deferred income taxes	(5,082)	(3,958)	1,124	(1,074)	(1,012)	62	(1,452)	(1,462)	(10)
Sales of held-for-sale mortgages	—	—	—	18,722	18,711	(11)	23,662	23,669	7
Change in trading securities	(1,913)	(1,922)	(9)	—	—	—	2,598	2,594	(4)
Change in accounts and other receivables, net	1,743	(711)	(2,454)	(1,237)	(763)	474	661	470	(191)
Change in accrued interest payable ..	(301)	(263)	38	713	718	5	282	290	8
Change in guarantee asset, at fair value	(1,986)	(2,203)	(217)	(987)	(1,125)	(138)	(567)	(726)	(159)
Change in guarantee obligation	4,515	4,245	(270)	1,540	1,536	(4)	1,413	1,779	366
Participation Certificate residuals, at fair value	2,416	—	(2,416)	6	—	(6)	112	—	(112)
Other, net	1,131	3,443	2,312	445	(489)	(934)	43	339	296
Net cash provided by (used for) operating activities	<u>1,658</u>	<u>2,135</u>	<u>477</u>	<u>22,453</u>	<u>22,275</u>	<u>(178)</u>	<u>31,290</u>	<u>31,502</u>	<u>212</u>
Cash flows from investing activities									
Proceeds from sales of available-for-sale securities	109,967	109,973	6	86,745	86,745	—	94,961	95,029	68
Proceeds from maturities of available-for-sale securities	219,263	219,047	(216)	—	—	—	—	—	—
Derivative premiums and terminations and swap collateral, net	833	(2,484)	(3,317)	(97)	910	1,007	932	(6,859)	(7,791)
Net cash provided by (used for) investing activities	<u>330,063</u>	<u>326,536</u>	<u>(3,527)</u>	<u>86,648</u>	<u>87,655</u>	<u>1,007</u>	<u>95,893</u>	<u>88,170</u>	<u>(7,723)</u>
Cash flows from financing activities									
Proceeds from issuance of short-term debt	1,018,040	1,016,933	(1,107)	—	—	—	—	—	—
Repayments of short-term debt	(990,646)	(986,489)	4,157	(766,598)	(767,427)	(829)	(862,176)	(854,665)	7,511
Net cash provided by (used for) financing activities	<u>27,394</u>	<u>30,444</u>	<u>3,050</u>	<u>(766,598)</u>	<u>(767,427)</u>	<u>(829)</u>	<u>(862,176)</u>	<u>(854,665)</u>	<u>7,511</u>
Net change in cash and cash equivalents	<u>\$ 359,115</u>	<u>\$ 359,115</u>	<u>\$ 0</u>	<u>\$(657,497)</u>	<u>\$(657,497)</u>	<u>\$ 0</u>	<u>\$(734,993)</u>	<u>\$(734,993)</u>	<u>\$ 0</u>
Supplemental cash flow information									
Cash paid (received) for:									
Debt interest	37,918	37,473	(445)	34,452	33,973	(479)	26,797	26,467	(330)
Swap collateral interest	—	445	445	—	479	479	—	322	322

(1) 2007 As reported with changes in accounting principles and 2006 and 2005 As Adjusted amounts exclude adjustments which were made to our consolidated Statement of Cash Flows to conform to current period presentation.

END OF FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

QUARTERLY SELECTED FINANCIAL DATA

The unaudited financial data for each quarter and full-year 2007 and 2006 reflects the reconciliation of previously reported to adjusted captions on the consolidated statements of income. See “NOTE 20: CHANGES IN ACCOUNTING PRINCIPLES” to our consolidated financial statements for more information regarding the adjustments.

	2007				
	1Q	2Q	3Q	4Q	Full-Year
	(in millions, except share-related amounts)				
Net interest income, as computed without changes in accounting principles	\$ 978	\$ 973	\$ 987	\$ 972	\$ 3,910
Impact of changes in accounting principles	(207)	(180)	(226)	(198)	(811)
Net interest income, as adjusted	<u>\$ 771</u>	<u>\$ 793</u>	<u>\$ 761</u>	<u>\$ 774</u>	<u>\$ 3,099</u>
Non-interest income (loss), as computed without changes in accounting principles	\$ (554)	\$ 1,282	\$ (1,665)	\$ (3,815)	\$ (4,752)
Impact of changes in accounting principles	477	267	1,782	2,420	4,946
Non-interest income (loss), as adjusted	<u>\$ (77)</u>	<u>\$ 1,549</u>	<u>\$ 117</u>	<u>\$ (1,395)</u>	<u>\$ 194</u>
Non-interest expense, as computed without changes in accounting principles	\$ (1,074)	\$ (1,378)	\$ (2,731)	\$ (3,163)	\$ (8,346)
Impact of changes in accounting principles	(150)	(141)	(339)	(294)	(924)
Non-interest expense, as adjusted	<u>\$ (1,224)</u>	<u>\$ (1,519)</u>	<u>\$ (3,070)</u>	<u>\$ (3,457)</u>	<u>\$ (9,270)</u>
Income tax (expense) benefit, as computed without changes in accounting principles	\$ 439	\$ (113)	\$ 1,380	\$ 2,301	\$ 4,007
Impact of changes in accounting principles	(42)	19	(426)	(675)	(1,124)
Income tax (expense) benefit, as adjusted	<u>\$ 397</u>	<u>\$ (94)</u>	<u>\$ 954</u>	<u>\$ 1,626</u>	<u>\$ 2,883</u>
Net income (loss), as computed without changes in accounting principles	\$ (211)	\$ 764	\$ (2,029)	\$ (3,705)	\$ (5,181)
Impact of changes in accounting principles	78	(35)	791	1,253	2,087
Net income (loss), as adjusted	<u>\$ (133)</u>	<u>\$ 729</u>	<u>\$ (1,238)</u>	<u>\$ (2,452)</u>	<u>\$ (3,094)</u>
Basic earnings (loss) per common share, as computed without changes in accounting principles ⁽¹⁾	\$ (0.46)	\$ 1.02	\$ (3.29)	\$ (5.91)	\$ (8.58)
Impact of changes in accounting principles ⁽¹⁾	0.11	(0.05)	1.22	1.94	3.21
Basic earnings (loss) per common share, as adjusted ⁽¹⁾	<u>\$ (0.35)</u>	<u>\$ 0.97</u>	<u>\$ (2.07)</u>	<u>\$ (3.97)</u>	<u>\$ (5.37)</u>
Diluted earnings (loss) per common share, as computed without changes in accounting principles ⁽¹⁾	\$ (0.46)	\$ 1.02	\$ (3.29)	\$ (5.91)	\$ (8.58)
Impact of changes in accounting principles ⁽¹⁾	0.11	(0.06)	1.22	1.94	3.21
Diluted earnings (loss) per common share, as adjusted ⁽¹⁾	<u>\$ (0.35)</u>	<u>\$ 0.96</u>	<u>\$ (2.07)</u>	<u>\$ (3.97)</u>	<u>\$ (5.37)</u>
	2006				
	1Q	2Q	3Q	4Q	Full-Year
	(in millions, except share-related amounts)				
Net interest income, as previously reported	\$1,131	\$1,172	\$ 959	\$ 973	\$ 4,235
Impact of changes in accounting principles	(192)	(189)	(230)	(212)	(823)
Net interest income, as adjusted	<u>\$ 939</u>	<u>\$ 983</u>	<u>\$ 729</u>	<u>\$ 761</u>	<u>\$ 3,412</u>
Non-interest income (loss), as previously reported	\$1,347	\$ 979	\$ (868)	\$ (543)	\$ 915
Impact of changes in accounting principles	201	199	404	367	1,171
Non-interest income (loss), as adjusted	<u>\$1,548</u>	<u>\$1,178</u>	<u>\$ (464)</u>	<u>\$ (176)</u>	<u>\$ 2,086</u>
Non-interest expense, as previously reported	\$ (584)	\$ (714)	\$ (827)	\$ (922)	\$ (3,047)
Impact of changes in accounting principles	(30)	(35)	(19)	(85)	(169)
Non-interest expense, as adjusted	<u>\$ (614)</u>	<u>\$ (749)</u>	<u>\$ (846)</u>	<u>\$ (1,007)</u>	<u>\$ (3,216)</u>
Income tax (expense) benefit, as previously reported	\$ 115	\$ (40)	\$ 21	\$ 12	\$ 108
Impact of changes in accounting principles	(46)	(36)	10	9	(63)
Income tax (expense) benefit, as adjusted	<u>\$ 69</u>	<u>\$ (76)</u>	<u>\$ 31</u>	<u>\$ 21</u>	<u>\$ 45</u>
Net income (loss), as previously reported	\$2,009	\$1,397	\$ (715)	\$ (480)	\$ 2,211
Impact of changes in accounting principles	(67)	(61)	165	79	116
Net income (loss), as adjusted	<u>\$1,942</u>	<u>\$1,336</u>	<u>\$ (550)</u>	<u>\$ (401)</u>	<u>\$ 2,327</u>
Basic earnings (loss) per common share, as previously reported ⁽¹⁾	\$ 2.81	\$ 1.93	\$ (1.17)	\$ (0.85)	\$ 2.84
Impact of changes in accounting principles ⁽¹⁾	(0.10)	(0.09)	0.25	0.12	0.17
Basic earnings (loss) per common share, as adjusted ⁽¹⁾	<u>\$ 2.71</u>	<u>\$ 1.84</u>	<u>\$ (0.92)</u>	<u>\$ (0.73)</u>	<u>\$ 3.01</u>
Diluted earnings (loss) per common share, as previously reported ⁽¹⁾	\$ 2.80	\$ 1.93	\$ (1.17)	\$ (0.85)	\$ 2.84
Impact of changes in accounting principles ⁽¹⁾	(0.09)	(0.09)	0.25	0.12	0.16
Diluted earnings (loss) per common share, as adjusted ⁽¹⁾	<u>\$ 2.71</u>	<u>\$ 1.84</u>	<u>\$ (0.92)</u>	<u>\$ (0.73)</u>	<u>\$ 3.00</u>

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