

A N N U A L 2 0 0 7 R E P O R T

C O M P A N Y O V E R V I E W

Freddie Mac's mission is to provide liquidity, stability and affordability to the U.S. housing and mortgage markets. That mission—defined in our congressional charter—forms the framework of our business lines, shapes the products we bring to market and drives the services we provide to the nation's housing and mortgage finance industry.

Liquidity: Freddie Mac serves the secondary mortgage market by providing a stable supply of money for lenders, which lowers rates for millions of consumers.

Stability: Freddie Mac plays a vital role by moderating cyclical swings in the housing sector, equalizing the flow of mortgage funds regionally throughout the United States and making mortgage funds available in a variety of economic conditions.

Affordability: Freddie Mac provides financing options that increase opportunities for affordable homeownership and affordable rental housing for families across the nation.

A MESSAGE FROM THE CHAIRMAN

TO OUR STOCKHOLDERS:

In 2007, our sector suffered the most severe housing correction since the Great Depression. In my 35 years as an economist, central banker, regulator and businessman, I have never witnessed a situation quite like this one—in which a housing bubble has played such a central role in bringing the world's largest economy to the brink of recession.

Freddie Mac's financial results last year were acutely affected by the extraordinary downturn in housing; later in this letter I will discuss them with you fully. But before detailing our performance, it's worth taking a closer look at *how* and *why* the housing finance environment became so challenging. If you'll bear with me, I'd like to describe what we've observed, what we've been doing about it, and what we think it means.

WHAT HAPPENED?

While many of the difficulties began in the subprime mortgage market, it's important to understand that what the markets face today is a broader problem of transparency and confidence. In one area after another, markets have ceased functioning as creditors have lost confidence in the portfolios of their lending partners.

Looking back over the problems of the past year, at least three factors contributed to the sharp declines we saw. First was a global glut of liquidity, resulting in part from the rapid rise of the world's largest emerging economy, China, as a net exporter of both capital and, in effect, of labor. Second were advances in technology and financial engineering that separated lending decisions from investment decisions. Third was a decline in underwriting standards, as too many lenders and borrowers threw caution to the winds.

In the process, the subprime mortgage was transformed from a niche product and used far more indiscriminately than in the past. Housing finance was stretched beyond the breaking point by ever-more exotic mortgages that enabled more home buying on the front end but carried unacceptable risks of home loss on the back end as soon as home prices stopped rising.

Of course, markets correct—and this time, they did so rapidly and viciously. Indeed, the markets may have already *overcorrected* in pricing and in underwriting certain products, such as jumbo mortgages, outside the conforming space. To a large extent, only the conforming market served by the housing government-sponsored enterprises (GSEs) has continued to function normally, in the process diminishing risk and saving families thousands of dollars in payments over the lifetimes of their loans.

SOME LESSONS LEARNED

In recent months, many policymakers have discussed options to ease stresses on the housing and mortgage markets. Many of these efforts have merit, most specifically the fiscal stimulus program to avert the risk of recession. While the Federal Reserve has been creative and responsible in dealing with the problem, we also need to realize that there are very real limits to what monetary policy can do in a situation like this. It is, as often said, a very “blunt” instrument. So we should all applaud the Administration and the Congress for delivering a timely stimulus package. To my mind, *when* it was passed is more important than all the exact elements of *what* it contained.

The problems in the subprime market remind us of a longstanding truth that was nearly obscured during the last years of the long housing boom: not every family that wants to own a home is financially ready for homeownership. To understand why this is so, consider the subprime market, which can be roughly divided into three parts.

The top group of subprime loans might have been eligible for prime credit, but for one reason or another ended up in the subprime category. A middle group of loans are legitimately in subprime, but should benefit from enhanced underwriting standards and more reasonable reset terms. Finally, a sizable bottom group of subprime loans may not have been repayable in any reasonable scenario unless home prices continued to escalate.

I am an ardent proponent of the long-term benefits of homeownership. That also makes me an ardent opponent of practices that unduly raise the risk of foreclosure. We need to face the fact that, as a matter of both policy and attitude, our nation did not sufficiently question whether homeownership is the right thing for every household in America at every point in time. For

most homeowners in the bottom group of subprime today, it may be better to be renters than homeowners at this point in the cycle. That's how it was when many of us grew up.

Accordingly, some of the housing stock that is now or soon will be facing the threat of foreclosure will likely need to be converted, at least temporarily, into rental housing. So it makes sense to undertake efforts that would enable at least some of the families that briefly owned the properties to stay in them under certain circumstances, whether as ordinary renters, or on some kind of innovative shared-equity, rent-to-own or lease-to-buy basis. The specifics would have to be worked out as a matter of law and policy. But what's already clear is that the right kinds of creative solutions would be better than foreclosure—for lenders, families and neighborhoods alike.

One lesson I hope we all absorb from last year's experience is that housing finance alone cannot resolve all the housing affordability challenges facing our nation. To achieve lasting gains in affordability, advances in mortgage finance must be accompanied by changes affecting the supply side of the housing equation—such as in zoning, permitting, transportation and other policies.

In sum, we need a change of perspective, emphasizing *sustainable* homeownership—homes that families can afford to buy and keep—over mere *homebuying*. Any other approach elevates statistics over human lives: the short-term satisfaction of telling ourselves the homeownership rate is increasing, when what really matters is the long-term strength of our families, our neighborhoods and our economy, as shown by the events of 2007.

That's a perspective on the extraordinary developments of the last year. Now let's take a closer look at how Freddie Mac has managed its way through them—starting with our progress in financial reporting.

ADVANCES IN FINANCIAL REPORTING

We have reached a major milestone on Freddie Mac's road back to normalcy. With the publication of this 2007 annual report, we are again timely in our financial reporting. This has taken a lot of time, effort and resources, but the benefits are substantial. While much remains to be done, the company and its employees have taken an important step forward.

Our advances in financial reporting go beyond timeliness. We continued to strengthen our accounting and internal controls infrastructure. To enhance transparency, we have updated several key accounting policies so as to enhance our GAAP disclosures. We are debuting in this annual report a new segment measure that will more clearly convey the specific risk/reward characteristics of our three lines of business—and also enable investors to better assess this firm's performance relative to its peers.

All this progress in financial reporting brings important benefits: We can be more transparent to our investors, more comparable to other financial services companies, and more focused on our business and our mission.

FINANCIAL RESULTS AND KEY TRENDS

As I've said, 2007 was an especially difficult year in many ways. The worsening environment made it very hard for any company in the housing sector to be profitable. This brought even greater challenges for a GSE like Freddie Mac, whose congressional charter limits us to serving only the U.S. residential mortgage market. Unlike other financial services companies, we did not have the option of shifting our focus or withdrawing from the mortgage markets. Rather, as required by our charter, Freddie Mac provided liquidity and stability to the conforming market—even as others pulled back and provided neither. In so doing, we continued to support our customers and serve our public mission at a critical time.

As a result, only the conventional, conforming market supported by the GSEs was able to function more or less normally. Indeed, many observers made the point that if not for the GSEs in the conforming market, there would have been very little of a healthy U.S. mortgage market during this period.

However, clearly last year's weakening house prices and punishing deterioration of credit hurt Freddie Mac's results, along with those of other mortgage market participants. On a GAAP basis, based on the accounting policy changes I mentioned earlier, our 2007 net losses amounted to roughly \$3.1 billion, or \$5.37 per diluted share, compared with 2006 net income of \$2.3 billion. These results reflected substantial losses on mark-to-market items and a higher provision for credit losses. Our mark-to-market losses of \$8.1 billion mainly included \$4.3 billion in interest-rate related items and \$3.9 billion in credit-related items, offset by certain fees. Our provision for credit losses of \$2.9 billion reflected the significant worsening of mortgage credit resulting from continued weakness in housing.

These results are plainly disappointing and put pressure on our capital, which is determined by GAAP. Looking across the U.S. financial services landscape, it's clear that a number of other financial institutions experienced larger losses relative to the size of their mortgage portfolios. But as a company that prides itself on our singular focus and expertise in managing mortgage risk, we can and must do better—even in the most challenging environments. Later in this letter, I'll describe some of the steps we are taking to do so.

It is essential to note that a significant portion of our losses were not economic, but the result of accounting conventions. Freddie Mac is committed to serving our mission for the long term and building enduring shareholder value. Yet in our business, mark-to-market accounting has the effect of increasing volatility and often requires us to book losses in excess of those that we ultimately expect to incur. Thus, a significant fraction of the credit impact from our current guarantee portfolio has already been reflected in our results. We expect a good portion of the “front-loaded” mark-to-market losses in our GAAP results will ultimately reverse over time.

There is a related dynamic at work here. Much of what Freddie Mac did in 2007 served our mission in ways that hurt our GAAP results in the short term. For example, the day we buy a loan and issue a credit guarantee, we have to mark the credit to market—and in this environment, that’s generating large current-period losses (commonly called day one losses). Yet over the long run, with robust growth in our guarantee-fee business and wider spreads resulting from enhanced underwriting standards and increased guarantee fees, we expect the 2008 business we’re putting on today to generate attractive returns tomorrow.

In order to communicate our business results in a manner consistent with how we manage our business—and as discussed in our *Management’s Discussion and Analysis* (MD&A)—we are providing supplementary new disclosures and segment reporting in this annual report. These new disclosures show clearly the results of our underlying lines of business. Investors have asked for such an additional measure for several years, and Chief Financial Officer Buddy Pizsel deserves great credit for bringing it to fruition. On the basis of the new measure (which we call Adjusted operating income, or AOI), our earnings totaled \$2.1 billion for 2007, down from \$3.9 billion on this basis for 2006. That decline is consistent with the credit costs we experienced. (AOI is a non-GAAP financial measure. For a reconciliation of AOI to GAAP and for more on AOI and our new segment reporting, please see the MD&A and Note 15 of this annual report.)

BUSINESS PERFORMANCE AND PROSPECTS

Overall, I believe the market shift we saw in 2007 toward fixed-rate originations and improved pricing and credit standards positions Freddie Mac well, enabling us to build on our traditional strengths. Let me explain why.

One key reason management believes strongly in Freddie Mac’s future is the quality of our book of business, which we view as among the very best in the industry. Compared to our competitors, our mortgage portfolio is low in loan-to-value, low in holdings of exotic loans, high in regional diversification and high in credit quality. For example, following a year of marked deterioration in

credit, our total single-family delinquency rate on December 31, 2007 was 65 basis points, still less than half the industry average—and well below that of our principal competitor. While we expect this to rise, it should remain substantially lower than others. As evident in our disclosures, even in a deteriorating credit environment, we believe our sound credit standards and policies will stand us in good stead.

A second positive factor involves *how* the markets have come back in our direction, in terms of quality as well as volume. Growth in total U.S. residential mortgage debt outstanding slowed to roughly 7 percent in 2007. By contrast, our total portfolio grew by 15 percent last year as Americans remembered the virtues of the American Mortgage—the long-term, fixed-rate, prepayable mortgage that remains a sweet spot for Freddie Mac. Moreover, across a range of products, much of the irresponsibility in pricing and credit began to be wrung out of the system.

The shift away from exotic mortgages and back toward long-term, fixed-rate lending and more rational underwriting standards puts your company in a solid position going forward. Our guarantee-fee income increased throughout the year, based on credit guarantee portfolio growth of almost 18 percent. At the same time as we grew volume and gained overall market share, we have also moved to raise prices in our credit guarantee business to better reflect changing credit and market conditions. As a result, we expect revenues from our guarantee business to increase materially in 2008. The aggregate price increases were substantial but they were needed—and were accompanied by tightened and more risk-based credit standards as well.

Net interest margin stabilized throughout the year, in large part a function of increased spreads and reduced average volumes. With the current illiquidity and lack of demand elsewhere in the mortgage security market, the option-adjusted spreads we are able to earn on new business have improved significantly.

Our multifamily business showed striking growth. This increasingly important part of our business—which is a “goal rich” contributor to our affordable housing goals—eclipsed its previous record set in 2006 by almost 55 percent. Consistent with the accelerating momentum of our business as a whole, the lion’s share of this growth occurred in the second half of the year.

The company remains safe and sound, and we continue to enhance our capital management and financial controls. We began the year with an estimated \$2.1 billion capital cushion above the 30 percent surplus directed by our regulator; at year-end, this cushion stood at an estimated \$3.5 billion. Credit quality is high, as discussed, and interest rate risk management remains strong. Finally, we continued to strengthen our safety and soundness regime by taking advantage of opportunities to enhance our senior management team.

In November, facing GAAP losses that we knew would count against our regulatory capital, we faced a fundamental decision about the company's direction. We could radically shrink the firm—and thus shirk our mission—in order to conserve capital, or we could take the hard decision to raise additional capital and halve the dividend. We chose the latter course, and in the days that followed, we found that many of America's shrewdest institutional investors share our strong confidence in the future of this franchise. We were thus able to successfully raise \$6 billion in a preferred stock offering that was greatly oversubscribed—and which, importantly, avoided any dilution of existing common stockholders.

We believe this additional capital will enable Freddie Mac to continue fulfilling its urgent mission and better position us to effectively manage the company going forward. In doing so, we must treat capital as a precious resource and manage it wisely. By its nature, the guarantee-fee business is less capital intensive than the investment portfolio business. Accordingly, you can anticipate that we will work to derive a greater share of Freddie Mac's value from the guarantee business going forward. Be assured that this does not represent a lack of interest in pursuing investment portfolio opportunities, but rather, is simply a matter of balance, emphasis and prudence.

Controlling G&A costs is a key to Freddie Mac's competitive prospects. We held administrative expenses flat in 2007 and actually reduced them slightly as a percentage of our total portfolio. This year, we expect to achieve further savings by shedding substantial consultant headcount associated with our accounting systems improvements, which are largely winding down. In 2009, we plan to extend these savings through voluntary attrition and other steps as necessary.

I want to turn very briefly from our efforts to save money at Freddie Mac, to our plans to invest in enhancing the capabilities of the business. In recent years we have had to devote the bulk of our new spending to upgrade our accounting infrastructure and internal controls. As that effort nears completion, we will be able to reinvigorate our efforts and our spending to improve the company's products, time to market and customer service.

Beyond that, I would single out three specific areas of focus. One, we are working to enhance our capabilities to meet all our customer needs and act as a conduit between the primary market where loans are originated and the investment world, including Wall Street. Two, we are taking steps to improve our security performance—the structure and liquidity of the currency we use to purchase mortgages. Finally, we are upgrading our systems to make Freddie Mac as easy as possible for our customers to work with. All these initiatives are intended to make us a stronger competitor when the secondary mortgage market again becomes intensely competitive.

A MISSION-CRITICAL YEAR

If last year's turmoil in the housing finance markets had any silver lining, it was this: though it was very hard for the GSEs to be profitable, it was also very hard to deny our necessity. Freddie Mac's mission is always important, but in 2007, it plainly was essential. We provided stability and liquidity to the mortgage market, even as our private-label competitors withdrew from it. As a result, in discussions across the ideological spectrum, we are seen as a part of the solution to the subprime and broader economic challenges facing the country.

Thus, in the fiscal stimulus package signed into law on February 13, 2008, the GSEs were entrusted with the important added responsibility of bringing relief to parts of the jumbo mortgage market. Our task is to provide liquidity, stability, and help enable lower costs in high-cost areas in such states as California—where thousands of middle class families and homebuyers are struggling with mortgages above the prior conforming loan limit of \$417,000. Doing so will pose a particular challenge for us in light of the capital demands of this task and the capital cushion to which we manage. But it is a task we embrace—because it is the right thing to do for our mission and for the broader economy.

Too often in recent years, as rising house prices, regional stability and easy access to products became the norm in housing finance, commentators have focused on just one aspect of our three-part mission, effectively contending that our sole responsibility was affordable housing. But in fact the importance of all three parts of our mission—especially the need for us to provide liquidity and stability to housing markets—was demonstrated very clearly last year.

Freddie Mac was created in part to cushion the impact of crises such as the one that paralyzed the markets in 2007. We have played such a role before—as we did after Hurricane Katrina, 9/11, and the implosion of Long-Term Capital Management—but the extent of last year's market turmoil was extraordinary. As a result, Freddie Mac stepped up its mortgage purchases, and by year-end had injected nearly \$580 billion in liquidity into the markets.

We took early, concrete steps to stabilize the markets and cushion the negative effects of the housing downturn on borrowers and communities. In February of last year, we became the first financial institution to announce tighter underwriting standards that limit payment shock for certain subprime borrowers. This is consistent with the leadership we have shown in other efforts to combat predatory lending. In April, we made a commitment to buy \$20 billion in consumer-friendly mortgages that provide better choices for subprime borrowers. Since May, we have bought roughly \$43 billion of prime rate mortgages that financed borrowers who previously may have found themselves in subprime.

Freddie Mac has long led the industry in helping borrowers pursue innovative alternatives to foreclosure. The company and our servicers helped nearly 47,000 borrowers avoid foreclosure and keep their homes in 2007—bringing to more than 200,000 the number of such workouts since the beginning of 2004. We also introduced new tools to help homeowners facing foreclosure recognize and avoid mortgage fraud.

All this work is in keeping with our conviction that while preventing home loss and harm to markets and neighborhoods may be less glamorous than opening the doors of homeownership, it is no less essential—especially at this point in the cycle. I am proud, as you should be also, of this company's extensive efforts last year to prevent foreclosures, combat predatory lending and strengthen sustainable homeownership.

Freddie Mac achieved a very strong affordable performance in 2007—despite the fact that curtailed subprime credit and tightened underwriting standards put affordable mortgage financing out of reach of many borrowers. We made extraordinary efforts to meet the increasingly demanding annual affordable housing goals, and while the U.S. Department of Housing and Urban Development makes the final determination, we believe we met the three main goals. Almost 56 percent of the nearly 3.3 million homes we financed last year were affordable to low- or moderate-income families. Freddie Mac also helped more than 360,000 first-time homebuyers with their mortgage financing. And our burgeoning multifamily business provided the financing for nearly 600,000 affordable apartment units around the country.

2007 saw the expansion of Freddie Mac's multilingual financial literacy program and our anti-predatory lending educational campaign. Since their inception, these programs together have reached well over 1.5 million people with important information about credit and the homebuying process. And continuing our efforts to rebuild the Gulf Coast, Freddie Mac helped to establish a \$4.5 million home renovation reserve fund in New Orleans, which will be used to rebuild hurricane-damaged properties and get families back into their homes.

A VIEW TO THE FUTURE

A dark cloud hung over the housing sector in 2007, and it has cast a growing shadow over the U.S. economy—and increasingly, the global economy as well. Freddie Mac has shared in the pain that afflicts our sector. And we have learned important lessons that we are applying going forward.

The markets are coming back in our direction. Fixed-rate lending is in demand; GSE share of the total market is up; unsustainable pricing, credit and underwriting have mostly headed for the exits.

With that said, no one pretends this painfully deep housing recession will be easy on this or any other company in our sector. For that matter, no one can responsibly say how long the downturn will be.

But I can say this with confidence: the housing finance companies that prosper most in the long term will be those that have built the strongest foundation for the future. And Freddie Mac, albeit with some difficulty, has built such a foundation in the last several years—one whose pillars include more transparent accounting; more robust internal controls; better products and systems; stronger customer relationships and service; a higher-performing corporate culture; a stronger, broader and deeper management team; and the financial wherewithal to compete and succeed over the long term.

In all likelihood, this will be my last annual letter to you as CEO of Freddie Mac. I have entered into a transition plan with the company's board of directors, under which we have agreed to separate the roles of CEO and chairman of the board. After splitting the roles, I expect to remain at the company as executive chairman until the end of 2009. We had expected this transition to occur this past summer, until my designated successor, Eugene McQuade, decided to return to his private sector banking roots. The search for the company's next CEO is underway and we all look forward to its successful completion.

As Freddie Mac shareholders, you have shown extraordinary patience in an extraordinary time. But let's remember that for all that has changed, very important long-term aspects of demography and demand have *not* changed—and are positive. America remains a growing developed nation: one with relatively high rates of birth, immigration and household formation. Long-term demand for housing finance will remain strong. And now, having built a firm foundation, Freddie Mac is positioned like very few other companies to benefit from the inevitable recovery of housing in this country.

So thank you for your fortitude and confidence in Freddie Mac. During this difficult time for housing and the economy, rarely have they been as needed or as beneficial for our nation. Yet also, from my perspective, rarely as well justified.

Sincerely,

A handwritten signature in black ink that reads "Dick Syron". The signature is written in a cursive, flowing style.

Richard F. Syron
Chairman and Chief Executive Officer

February 28, 2008

2007 ANNUAL REPORT TO STOCKHOLDERS