We make home possible℠

2003

ANNUAL REPORT

"…the most successful companies of all are those with a clear mission that they execute with ferocious focus."

Richard F. Syron, chairman and CEO

a message from the chairman

To Our Shareholders,

I am pleased to write you my first annual letter as chairman and CEO of Freddie Mac. Even in the very challenging year that led up to my arrival, the company delivered good financial results — which I'll discuss later in this message — while fulfilling our mission.

This past December, when the board of directors asked me to take on this job, I was deeply honored. That's because Freddie Mac is much more than one of the largest financial services companies in America. As a government-sponsored enterprise, or GSE, we have the vital public mission of helping American families achieve their dreams through low-cost homeownership. We also have the responsibility to keep our company financially safe, sound and strong. And I feel a powerful *personal* obligation — as in my preceding private-sector jobs — to be a vigilant steward of shareholder capital.

Let's start with the fundamentals. Freddie Mac operates in a highly attractive market: U.S. residential mortgage debt. Within this growing market, our congressional charter gives us special privileges and opportunities, along with special responsibilities. We have a strong foundation of capital and a well-earned reputation for managing interest-rate and credit risk. And Freddie Mac has done enormous good with its franchise. Over the years, we have made home possible for one in six homebuyers across America — helping them build wealth, and helping our nation build the world's finest system of housing finance.

But as we all know, major problems surfaced at Freddie Mac in 2003 — the same ones that brought me here. I have been highly impressed in my first nine months with the company's financial safety and soundness, risk management, core business and superb people. But I've also seen clearly the consequences of serious problems in accounting, internal controls and corporate governance that came to light last year.

My game plan has three basic parts:

1. Getting our house in order and rebuilding public confidence;
2. Making this a truly mission-driven company; and
3. Using these efforts to build long-term shareholder value.

We've made good progress in these areas, but much remains to be done. Let me tell you where things stand today and where I see Freddie Mac tomorrow.

Richard F. Syron, chairman and CEO

Getting Our House in Order

Getting our house in order has been my most urgent priority. My primary focus has been on rebuilding our senior management team to help us excel in an increasingly competitive market. So I am delighted that within the first nine months of 2004, we have been able to bring together a truly world-class group of senior executives.

getting our

house

in order

We have hired Gene McQuade as president and chief operating officer. Gene is the former president of Bank of America and chief operating officer of FleetBoston Financial, and he brings a wealth of operating and financial reporting experience to Freddie Mac. We also have brought on Patti Cook, a 25-year Wall Street veteran of the fixed-income markets, to serve as executive vice president of investments.

Other key additions include Ralph Boyd as executive vice president and general counsel, to manage our legal, government relations and communications functions. Ralph is a former Assistant U.S. Attorney General and head of the Justice Department's Civil Rights Division in the Bush Administration. Stan Martin, a veteran SEC reviewing partner with KPMG, is our new head of Internal Audit. Jerry Weiss, another of our Wall Street hires, is in the new post of chief compliance officer. Marty Baumann, our CFO, joined us in April 2003 and leads our ongoing accounting remediation effort. And Hollis McLoughlin, with a dual background in business and the public sector, is bringing both strategic focus and process discipline to bear as my chief of staff.

With these changes made, we will finish the job of getting our financial reporting where it needs to be. An important first step was meeting our commitment to report 2003 results within our self-imposed deadline of June 30, 2004. But our remediation is not yet complete. The truth is that our progress in building accounting systems and improving internal controls must accelerate and come to fruition. These weaknesses in processes and systems are preventing us from reporting our financials to you on a timely basis.

But Freddie Mac is doing more than hiring a new senior management team and fixing our accounting; we are enhancing our corporate governance as well. As a GSE in the Sarbanes-Oxley era, we must serve as a role model of sound corporate governance that inspires public trust. So we have adopted corporate governance guidelines — including criteria for board independence — that fully meet New York Stock Exchange listing standards, as well as SEC standards for audit committee independence. Moreover, we have met, on time, every element of our regulator's rigorous consent order. We have committed to split the roles of chairman and CEO, and laid the

"I am not a status quo leader and Freddie Mac will not be a status quo company."

groundwork to do so. We are requiring all board members to hold Freddie Mac stock, so they have a greater stake in the company's long-term success. And we are conducting an orderly transition of the board — so that, during the course of this year, we will see the turnover of about half of our elected board.

One milestone in our financial reporting will be registering our common stock with the SEC under the Securities Exchange Act of 1934 and filing 10-Ks and 10-Qs as a reporting company under the Act. We also recognize investors' need to understand our financial reporting better, so that we are more easily comparable with other large financial institutions. Meanwhile, we expect to deliver both quarterly and full-year 2004 results to you by March 31. And we will continue to be an accessible and accountable management team, providing quarterly conference calls, in the interim.

If all this strikes you as a lot of change, it is. I am not a status quo leader and Freddie Mac will not be a status quo company.

Becoming Mission-Driven

There's a big difference between being a company that happens to have a statutory mission, and being a company that is truly mission-driven. For too long, Freddie Mac acted like the former kind of company. I mean to make it indisputably the latter.

That is why we have retooled our performance measures to tie our senior managers' compensation to mission fulfillment as well as financial goals. We have dedicated first-rate staff and resources to focus entirely on ways for us to better understand and execute our mission. We are developing a number of initiatives to help us meet the affordable housing goals set forth by the federal government. And we have set for ourselves the ambitious strategic goal of leading the industry in expanding housing opportunities for underserved groups within five years.

becoming

mission

driven

These are significant steps. But to become truly mission-driven, Freddie Mac must foster a deeper understanding of our mission. Congress has given us an important public purpose: to enhance the liquidity, stability and affordability of America's mortgage markets. Freddie Mac gets high marks for providing liquidity and stability, but we need to do more on affordability. We must find ways to reach and serve minorities, immigrants, and others who are underserved today. This means innovating aggressively yet responsibly so that every household that can afford to buy and keep a home gets that opportunity, at lowest cost — and those who cannot or choose not to own, have quality, affordable rental alternatives. But Freddie Mac's mission is not only to assist the "affordable" end of the market. We cannot allow that noble goal to undermine or be set against our broader mission. For we have the statutory obligation to make America's housing finance markets work better for *everyone* we serve.

To succeed in carrying out our mission, Freddie Mac must do two things. As a GSE, we must continue working closely with Congress and the executive branch to modernize our regulatory structure. And as a company in a competitive marketplace, we must continue innovating, driving down our costs, and striving always to serve our customers better.

Building Shareholder Value

If that sounds like capitalism at work, it is. Which brings me back to you, our shareholders. My third and culminating priority is to ensure that Freddie Mac creates lasting value. Instead of managing to near-term expectations, I am determined to set our sights on building shareholder value that holds up over the long run.

If there is one thing that was never in question, it is this company's fundamental financial and economic strength and soundness. Our 2003 results bear out that confidence. We produced another strong year of earnings. We enhanced our strong capital position. We managed our interest-rate and credit risks to achieve impressive results. As a consequence, we posted strong fair value growth in a very challenging economic environment. Last year's results made it clear that Freddie Mac's franchise remained financially healthy, and the engine of our business produced good value.

Our 2003 results were fueled by strong portfolio growth and record business volume. No less important, we protected the value of our franchise during a volatile interest-rate environment, in which prepayments surged and rates moved by some 70 basis points in six months. Freddie Mac supported the largest refinancing market in history, while keeping our assets and liabilities well matched and our retained portfolio well hedged and insulated from major interest-rate swings. Our monthly reports demonstrated throughout the year that Freddie Mac's tradition of excellence in risk management is alive and well.

Still, we can do more and we can do better. For example, I am determined to attack our general and administrative expenses, which increased considerably due in part to our accounting remediation efforts. Once we gain efficiencies from the automated accounting and controls systems, our cost structure should normalize. And I am taking other steps to reduce our army of consultants and associated costs.

building

shareholder

value

Looking at the economic and competitive environment for this year, it's plain we can't continue to grow our retained mortgage portfolio at the extraordinary clip of the past decade (during which it increased more than ten-fold). For the reasons discussed in this annual report, our GAAP results will continue to show substantial volatility. And as also detailed in the report, if current conditions continue until year-end, our fair value growth, if any, is likely to be significantly below last

year's, when it exceeded our long-term expectations. It is important to note, however, that while fair value is an important means of measuring our returns, it is the trend of fair value growth over a multi-year period that provides a better yardstick of our success.

These cautions should not be interpreted to mean we don't have great opportunities — because we surely do. U.S. residential mortgage debt outstanding is expected to grow at the robust rate of more than eight percent annually for the next decade, and we expect to grow along with it. Moreover, consistent with our charter, when market conditions create a demand for us to increase our mortgage investment activity we will not hesitate to take advantage of profitable opportunities. This approach has enabled us to generate strong economic returns in a wide variety of market conditions.

Freddie Mac is well positioned to take advantage of opportunities in a growing market in part because we have an extremely strong capital base. We are currently holding 30 percent surplus core capital, under the capital monitoring framework created by our regulator, until we return to timely financial reporting. As soon as this requirement is lifted, we can and will consider opportunities to enhance shareholder return.

Leaner, more efficient companies are happier and more successful companies. And astute observers have realized that *the most successful companies of all are those with a clear mission that they execute with ferocious focus*. Indeed, mission-driven companies have the ability to create greater shareholder value than firms that are purely financially driven.

That is a big reason why Freddie Mac — as a mission-driven company conscious of its costs and of the need for constant innovation — is worthy of your continued confidence. We have a mission that benefits our society, motivates our employees, and has the support of our nation. And we understand that being mission-driven is not in tension with building shareholder value; rather, our charter is a *source* of shareholder value.

"If there is one thing that was never in question, it is this company's fundamental financial and economic strength and soundness."

Conclusion

I came to Freddie Mac with a mandate and a mind to take a great franchise, give it a new management team, fix its accounting, improve its corporate governance, and make this a truly mission-driven company whose relentless execution of its mission builds lasting shareholder value. I won't pretend this is an easy task, just as I wouldn't expect to turn an aircraft carrier on a

dime. But I have met with a great many people during my early months at Freddie Mac — shareholders, investors, business partners, regulators, competitors, employees, you name it. And it's striking that virtually every one of them sees us as a company with a vital public mission and bright long-term prospects. These people are right on the mark. We have made good progress in putting our problems behind us and are becoming a better company for it.

And as we move forward, let's remember that Freddie Mac's mission is not a headwind for this company. It is

"We have made good progress in putting our problems behind us and are becoming a better company for it."

a tailwind. Because our greatest gift from Congress is our clarity of mission. It means that all of us who serve Freddie Mac, from the board to the senior officers to middle managers to rank-and-file employees, are fortunate. By virtue of our clear public mission — and the market means by which we are chartered to achieve it — Freddie Mac does *well* precisely by doing *good*.

That is more than a proposition about our values. It is a value proposition.

Sincerely,

Richard F. Syron
Chairman and Chief Executive Officer

BOARD OF DIRECTORS (as of September 1, 2004)*

Richard F. Syron
Chairman and Chief Executive Officer
Freddie Mac
McLean, Virginia

Joan E. Donoghue
Senior Vice President and Principal Deputy General Counsel
Freddie Mac
McLean, Virginia

Michelle Engler
Trustee
JNL Investor Series Trust
and *Member of Board of Managers*
JNL Variable Funds
Both investment companies
Lansing, Michigan

Richard Karl Goeltz
Retired Vice Chairman and Chief Financial Officer
American Express Company
A financial services company
New York, New York

George D. Gould
Vice Chairman
Klingenstein, Fields & Company, LP
An investment management firm
New York, New York

Thomas S. Johnson
Chairman and Chief Executive Officer
GreenPoint Financial Corporation
A financial services company
New York, New York

Henry Kaufman
President
Henry Kaufman & Company, Inc.
An economic and financial consulting and investment management firm
New York, New York

William I. Ledman
Senior Vice President of Information Systems and Services
Freddie Mac
McLean, Virginia

John B. McCoy
Retired Chairman and Chief Executive Officer
Bank One Corporation
A financial services company
Columbus, Ohio

Shaun F. O'Malley
Chairman Emeritus
Price Waterhouse LLP
An accounting and consulting firm
Philadelphia, Pennsylvania

Ronald F. Poe
President
Ronald F. Poe & Associates
A mortgage banking company
White Plains, New York

Stephen A. Ross
Professor
Massachusetts Institute of Technology
Cambridge, Massachusetts

William J. Turner
Manager
Signature Capital, Inc.
A venture capital investment firm
Winnetka, Illinois

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

SENIOR MANAGEMENT (as of September 1, 2004)

Richard F. Syron — Chairman and Chief Executive Officer

Eugene M. McQuade — President and Chief Operating Officer

Martin F. Baumann — Executive Vice President, Finance and Chief Financial Officer

Ralph F. Boyd, Jr. — Executive Vice President, General Counsel and Corporate Secretary

Patricia L. Cook — Executive Vice President, Investments

David A. Andrukonis — Senior Vice President and Chief Enterprise Risk Officer

Donald J. Bisenius — Senior Vice President, Credit Policy and Portfolio Management

Margaret A. Colon — Senior Vice President and Chief Administrative Officer

Adrian B. Corbiere — Senior Vice President, Multifamily

Catherine M. Dondzila — Senior Vice President, Investments and Capital Markets Accounting

Joan E. Donoghue — Senior Vice President and Principal Deputy General Counsel

Nazir G. Dossani — Senior Vice President, Investments and Capital Markets

Cindy Gertz — Senior Vice President, Operational Risk Oversight

Edward L. Golding — Senior Vice President, Capital Oversight and Economics

Michael W. Hager — Senior Vice President, Human Resources

William I. Ledman — Senior Vice President, Information Systems and Services

Jerome T. Lienhard — Senior Vice President, Debt and Equity Financing

Stanley J.D. Martin — Senior Vice President and General Auditor

Michael C. May — Senior Vice President, Mortgage Sourcing, Operations and Funding

Hollis S. McLoughlin — Senior Vice President and Chief of Staff

Milton Moore — Senior Vice President, Technology Infrastructure and Operations

Dwight P. Robinson — Senior Vice President, Corporate Relations

Raymond G. Romano — Senior Vice President, Credit Risk Oversight

David H. Stevens — Senior Vice President, Mortgage Sourcing

Robert Y. Tsien — Senior Vice President, Mission Division

Jerry Weiss — Senior Vice President and Chief Compliance Officer

John F. Woods — Senior Vice President and Principal Accounting Officer

INFORMATION STATEMENT
AND
ANNUAL REPORT TO STOCKHOLDERS
For the fiscal year ended December 31, 2003

Freddie Mac is a stockholder-owned, government-sponsored enterprise, or GSE, established by Congress to provide a continuous flow of funds for residential mortgages. We perform this function primarily by buying and guaranteeing residential mortgage loans and mortgage-related securities, which we finance by issuing mortgage-related securities, debt securities and equity securities. Our securities are not required to be registered under the Securities Act of 1933 or the Securities Exchange Act of 1934 and we are not currently required to file periodic reports with the Securities and Exchange Commission under the Exchange Act. However, we are committed to the voluntary registration of our common stock under the Exchange Act, which we expect to complete once we return to timely financial reporting. We alone are responsible for making payments on our securities. Neither the United States nor any other agency or instrumentality of the United States is obligated to fund our mortgage purchase or financing activities or to guarantee our securities or other obligations.

The publication of this Information Statement and Annual Report, or Information Statement, has been delayed significantly, as a result of the ongoing controls remediation and systems re-engineering and development necessary to return to timely financial reporting following the previous revision and restatement of our financial results for 2002, 2001 and 2000. For more details, see "EXPLANATORY NOTE."

This Information Statement contains important financial and other information about Freddie Mac. The Information Statement will be supplemented periodically. All available supplements should be read together with this Information Statement. We also provide information about the securities we issue in the Offering Circular for each securities program and any supplement for each particular offering. You can obtain copies of the Information Statement, Offering Circulars, all available supplements, financial reports and other similar information by visiting our Internet website (www.FreddieMac.com) or by writing or calling us at:

Freddie Mac
Investor Relations Department
1551 Park Run Drive
McLean, Virginia 22102-3110
Telephone: 1-800-FREDDIE (800-373-3343) or 571-382-4732

Our principal offices are located at 8200 Jones Branch Drive, McLean, Virginia 22102 (telephone: 703-903-2000).

THIS INFORMATION STATEMENT IS DATED SEPTEMBER 24, 2004

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EXPLANATORY NOTE

This Information Statement contains forward-looking statements regarding our current expectations about objectives for financial reporting, future business plans, results of operations, financial condition, and trends. Forward-looking statements do not relate to historical matters and involve known and unknown risks, uncertainties and other factors, including those listed in the section titled "FORWARD-LOOKING STATEMENTS." We undertake no obligation to publicly update any forward-looking statement to reflect events or circumstances after the date of this Information Statement, or to reflect the occurrence of unanticipated events.

The publication of this Information Statement has been delayed significantly as a result of the ongoing controls remediation and systems re-engineering and development necessary to return to timely financial reporting following the previous revision and restatement of our financial results for 2002, 2001 and 2000. Although we are addressing the operational weaknesses that are contributing to our current inability to release financial results on a timely basis, uncertainty regarding the expected success, scope and timing of these activities remains. See "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, or MD&A, — RISK MANAGEMENT — Operational Risk — *Sources of Operational Risks.*"

Our current objective is to provide quarterly and full-year financial results for 2004 by March 31, 2005. Our delivery of both quarterly and full-year 2004 results in the first quarter of 2005 will enable us to resume quarterly financial reporting in 2005 on a timetable to be announced later this year. This decision allows our primary focus to be on our controls and systems remediation efforts (including those we are undertaking in accordance with the consent order we entered into with the Office of Federal Housing Enterprise Oversight, or OFHEO, discussed below) to address the material weaknesses and other deficiencies in our internal controls over financial reporting, as described in "MD&A — RISK MANAGEMENT — Operational Risk." This approach should permit us to complete a comprehensive assessment of the design of our internal controls before the next earnings release, an important step in our ongoing remediation efforts. At the same time, we expect to be able to make significant progress on our efforts to develop and build a fully capable systems infrastructure. These combined efforts will facilitate our return to timely financial reporting, enabling us to fulfill our commitment to register our common stock with the SEC under the Exchange Act.

Significant systems revisions are still required as a result of our adoption of revised accounting policies from the 2002 restatement and new accounting rules promulgated for 2003. While we have made substantial progress, we face continuing challenges because of the prior deficiencies in our accounting infrastructure and the operational complexities caused by the volume of revised and new accounting policies we have adopted.

Because most of our new systems are still in development, our current accounting close processes for period-end reporting are executed in two steps. First, we produce preliminary financial figures using our existing systems. Second, we adjust, or "remeasure," those figures using interim processes (which include several dependencies on manual, or off-line, accounting processes, as described in "MD&A — RISK MANAGEMENT — Operational Risk") to bring the figures into conformity with generally accepted accounting principles, or GAAP. As a result, we must complete substantial validation and analytical review procedures of our financial results to mitigate our current inability to rely extensively on more automated internal controls.

The continued existence of material weaknesses in our internal controls over financial reporting and the reliance on validation and analytical review procedures are highlighted by the fact that, in the course of the 2003 close process, we identified a number of immaterial errors in our previously published results, which were recorded as corrections in the first quarter of 2003. Although not material to the net income of 2003 or any prior year's published results, these errors evidence the higher level of operational risk that we are addressing. See "MD&A — CONSOLIDATED RESULTS OF OPERATIONS — NON-INTEREST INCOME (LOSS) — Other Income and Certain Prior Year Accounting Error Adjustments" for more information.

We are devoting extraordinary resources to systems and controls initiatives and have made significant progress. For example, we have implemented a controlled subledger system for our retained mortgage portfolio that captures accounting data for our mortgage security investment activities, replacing what had been a much more manual process dependent on end-user desktop systems. For the remainder of 2004 and into 2005, we will continue to re-engineer and build systems to eliminate our current two-step accounting close processes.

We believe that our overall timetable is appropriate in that it contemplates the necessary additional management due diligence processes for current financial reports in this challenging operating environment and the significant requirements for controls remediation and systems re-engineering and development that are needed to prepare us for the future. Our current plan is to brief the market, at least quarterly, beginning near the end of October 2004, regarding our business and progress toward, and timetable for, timely financial reporting.

While this Information Statement focuses on a presentation and analysis of our financial results for the years 2003, 2002 and 2001, it also includes selected information about certain topics pertaining to the year 2004 that are not affected by our current inability to produce timely financial statements.

While we are not yet subject to the SEC's disclosure requirements with respect to this Information Statement, we have attempted to comply with them to the extent possible. However, in some instances we have departed from specific SEC data requirements, principally in cases where we have provided data for fewer years than would be required if we were an SEC registrant. The omission of this data primarily arises because we have not restated our consolidated financial statements for periods prior to 2000. We do not believe the omissions are material to an understanding of our results for the periods presented.

In addition, this Information Statement and the certifications by our Chief Executive Officer and Chief Financial Officer, which are based on the certifications required of SEC registrants as to the accuracy and completeness of the information and the fair presentation of the consolidated financial statements and other financial information in periodic reports, do not address the effectiveness of our disclosure controls and procedures. This is because an evaluation of the effectiveness of these controls and procedures was not performed as of December 31, 2003. See "MD&A — RISK MANAGEMENT — Operational Risk — *Sources of Operational Risks*" for additional information regarding our internal control weaknesses and remediation efforts. On April 26, 2004, our Chief Executive Officer submitted to the New York Stock Exchange the certification required by Section 303A.12(a) of the New York Stock Exchange, or NYSE, Listed Company Manual regarding our compliance with the NYSE's corporate governance listing standards.

We released restated and revised financial statements for the years 2002, 2001 and 2000 on November 21, 2003 (collectively referred to as the "restatement"). On December 10, 2003, we announced that we had entered into a consent order and settlement generally resolving the investigation by OFHEO relating to our restatement of prior financial results. Under the terms of the consent order, we are undertaking remedial actions relating to governance, corporate culture, internal controls, accounting practices, disclosure and oversight. See "LEGAL PROCEEDINGS" and "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements for more information.

BUSINESS

Freddie Mac is one of the largest participants in the U.S. mortgage market. We are a stockholder-owned GSE chartered by Congress on July 24, 1970 under the Federal Home Loan Mortgage Corporation Act, as amended, which we refer to as the Freddie Mac Act or our charter.

Our statutory purposes are:

- To provide stability in the secondary market for residential mortgages;
- To respond appropriately to the private capital markets;
- To provide ongoing assistance to the secondary market for residential mortgages (including mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return received on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage finance; and
- To promote access to mortgage credit throughout the U.S. (including central cities, rural areas and other underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage finance.

We fulfill these statutory purposes primarily by purchasing residential mortgage loans and mortgage-related securities from mortgage lenders and securities dealers, financing these purchases with debt, equity and mortgage-related securities, and guaranteeing the payment of principal and interest on the mortgage-related securities we issue. For purposes of this discussion, and as further described in "Business Overview" below, the terms "purchase" and "mortgage purchase" encompass both the purchase of mortgages financed with debt and equity securities and the issuance of guaranteed securities representing undivided interests in mortgage loans and mortgage-related securities.

We purchase mortgages that finance homes in every geographic region of the U.S. In this way, we reduce the cost of homeownership and rental housing and improve the quality of life by making the American dream of decent, accessible housing a reality. For more than three decades, we have been a successful competitor in a large and consistently growing mortgage debt market.

Our principal offices are located in McLean, Virginia. We have additional offices in Washington, D.C.; Reston, Virginia; Atlanta, Georgia; Chicago, Illinois; Dallas, Texas; New York, New York; and Woodland Hills, California. As of August 25, 2004, we had 4,844 full-time and 150 part-time employees.

We do not currently file periodic reports with the SEC, although we will begin to do so upon completion of the voluntary registration of our common stock under the Exchange Act. We make our financial disclosure documents available free of charge on our website. Our corporate governance guidelines, Codes of Conduct for employees and members of the Board of Directors and the charters of the Board's five standing committees, (*i.e.*, the Audit, Finance and Capital Deployment, Mission and Sourcing, Governance and Nominating, and Compensation and Human Resources Committees) are also available on our website. Printed copies of these documents may be obtained upon request. Our Internet address is www.FreddieMac.com. (We are providing this Internet address solely for the information of interested persons. We do not intend this Internet address to be an active link, and are not using references to this address here or elsewhere in this Information Statement to incorporate additional information into this Information Statement.)

Financial Information about Segments

We did not meet the criteria for reporting business segments that are prescribed in Statement of Financial Accounting Standards, or SFAS, No. 131, "Disclosures About Segments of an Enterprise and Related Information," or SFAS 131, for any period presented in this report. For example, we did not maintain, as required by SFAS 131, discretely available and reliable financial information that we used to allocate internal resources and to evaluate the performance of internal business units. As a result, we have determined that we have only one business segment for financial reporting purposes.

Business Overview

We play a fundamental role in the American housing finance system, linking the domestic mortgage market and the global capital markets. In this role, we focus on the following strategies:

- Maintaining the lowest possible cost of financing for our mortgage investments by creating broader and more liquid markets for our mortgage-related and debt securities;
- Delivering these low-cost funds to a broad spectrum of America's homeowners by bringing innovation and efficiency to the mortgage market; and
- Managing the operational risk, interest-rate risk, credit risk and other business and market risks that arise from these business activities.

We participate in the secondary mortgage market principally by providing our credit guarantee for residential mortgages originated by mortgage lenders, and investing in mortgages and mortgage-related securities and holding them in our Retained portfolio. These activities, which include our credit guarantee activities and our portfolio investment activities, are summarized below:

Credit Guarantee Activities We purchase residential mortgage loans originated by mortgage lenders as well as mortgage-related securities. One of the means by which we fund purchases of mortgage loans is through the use of securitization-based financing. That is, we fund the purchases of such financial assets by issuing undivided interests in purchased mortgage loans and selling such interests to investors. Such undivided interests are referred to as Mortgage Participation Certificates, or PCs. Most of our credit guarantee activity occurs through the Guarantor Program in the form of mortgage swap transactions. In a mortgage swap transaction, a mortgage lender or other seller delivers mortgages to us in exchange for our PCs. Mortgage lenders and other originators also sell mortgages to us for cash through our Cash Window Program. In these cash transactions, we decide whether to hold the mortgage loans in our Retained portfolio and finance them by issuing debt and equity securities (portfolio investment), or sell them in the secondary market in the form of PCs that carry our guarantee of payment of principal and interest (credit guarantee). Mortgages we purchase for cash that we do not retain are pooled together with other mortgage loans we receive in connection with MultiLender Swaps. MultiLender Swaps are PC swap-based transactions that we execute with various lenders.

Our guarantee activities also involve the resecuritization of mortgage-related securities. In the resecuritization process, we issue securities representing undivided interests in PCs and certain other types of mortgage-related securities. We refer to securities that we issue through our resecuritization activities as Structured Securities. We resecuritize PCs, non-Freddie Mac mortgage-related securities and other already issued Structured Securities. We commonly transfer Structured Securities to third parties in exchange for either cash or the collateral underlying the Structured Securities (e.g., mortgage-related securities that third-party securities dealers deliver to us).

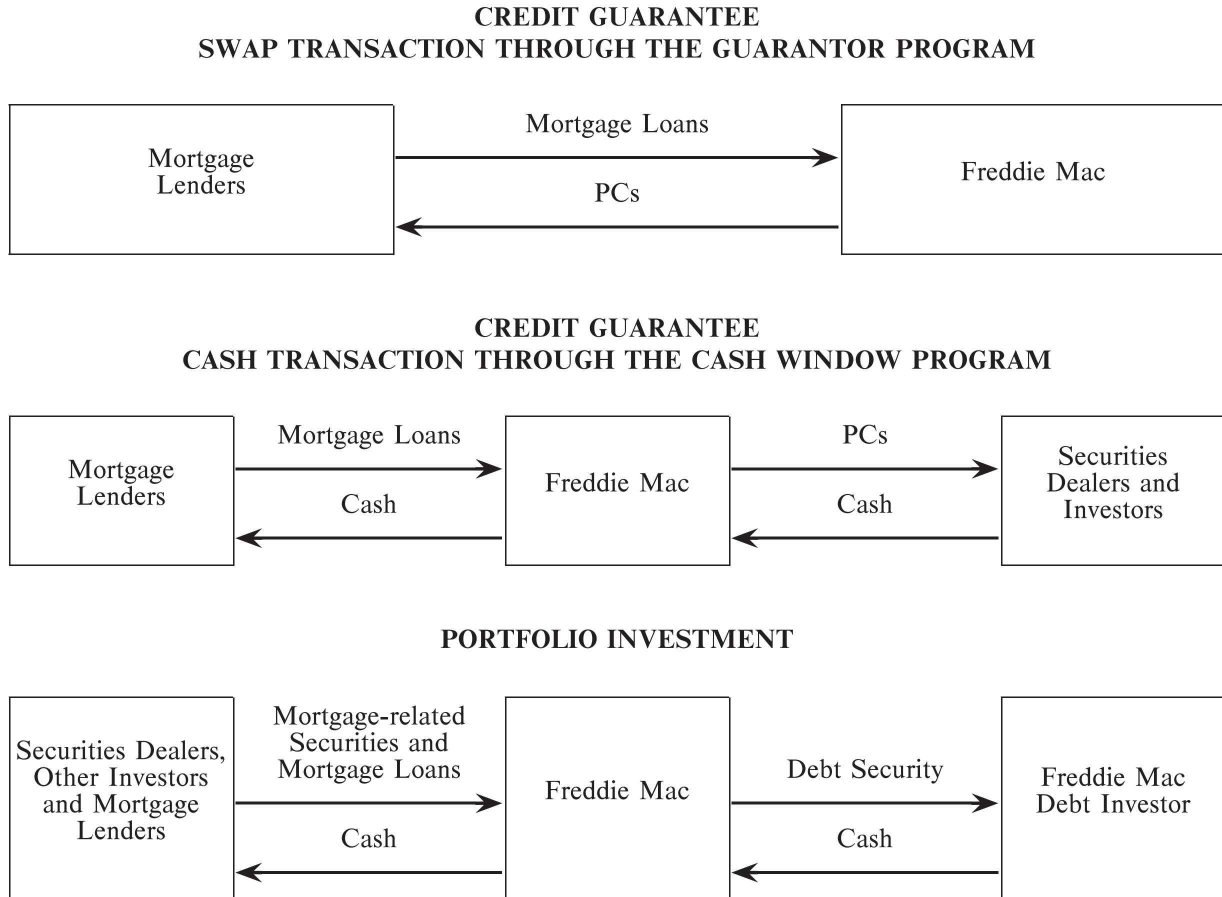
We provide a guarantee of the payment of principal and interest on tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties. These housing revenue bonds are collateralized by mortgage loans on low- and moderate-income multifamily housing projects. In addition, we guarantee the payment of principal and interest related to low- and moderate-income multifamily mortgage loans that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds. The unpaid principal amounts of the underlying mortgage loans are included within the definition of PCs and Structured Securities. For further details, see "NOTE 4: FINANCIAL GUARANTEES" to the consolidated financial statements. We guarantee payment of principal and interest on all issued PCs and Structured Securities. Mortgage-related assets that back PCs and Structured Securities held by third parties are not included in our consolidated financial statements. However, our obligation to provide the payment of principal and interest on issued PCs and Structured Securities usually results in the recognition of a guarantee asset and guarantee obligation on our consolidated balance sheets. For further details, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements.

Portfolio Investment We purchase mortgage loans and mortgage-related securities (including PCs and Structured Securities we previously issued to third parties) and hold such securities in our Retained portfolio for investment purposes. We finance these purchases by issuing debt and equity securities. Portfolio investments (including PCs in our Retained portfolio) are recorded on our consolidated balance sheets as assets within our Retained portfolio.

Our Retained portfolio consists of our investments in mortgage loans and mortgage-related securities, including PCs and Structured Securities we previously issued that we have acquired.

Figure 1 illustrates our basic credit guarantee and portfolio investment activities:

Figure 1



Our total mortgage portfolio is an important measure of our business activity. It consists of:

- PCs and Structured Securities (which are Freddie Mac securities) we hold in our Retained portfolio;
- Non-Freddie Mac mortgage-related securities we hold in our Retained portfolio, including securities issued by the Federal National Mortgage Association, or Fannie Mae, securities guaranteed by the Government National Mortgage Association, or Ginnie Mae, non-agency securities and obligations of states and political subdivisions;
- Mortgage loans we hold in our Retained portfolio;
- PCs and Structured Securities we hold for our PC market-making and support activities; and
- PCs and Structured Securities that third parties hold.

Table 1 provides information about the composition of our total mortgage portfolio as of December 31, 2003 and 2002 based on unpaid principal balances. Our total mortgage portfolio as presented in Table 1 includes the unpaid principal balances of mortgages and mortgage-related securities held in our Retained portfolio and the balance of PCs and Structured Securities held by third parties, or Outstanding PCs and Structured Securities, which are not included on our consolidated balance sheets. For the purposes of Table 1, the unpaid principal balances only reflect all PCs issued and that portion of Structured Securities backed by non-Freddie Mac mortgage-related securities. The unpaid principal balances of Structured Securities representing the resecuritization of PCs or previously issued Structured Securities are excluded because these issuances do not significantly increase our credit exposure or expected future cash flows.

Table 1 — Freddie Mac's Total Mortgage Portfolio Based on Unpaid Principal Balances(1)(2)

	December 31,			
	2003		2002	
	Dollars in Millions	% of Total Mortgage Portfolio	Dollars in Millions	% of Total Mortgage Portfolio
Outstanding PCs and Structured Securities(3)(4)	$ 752,164	53%	$ 729,809	55%
Retained portfolio:				
PCs and Structured Securities	393,135	28	341,287	26
Non-Freddie Mac mortgage-related securities:				
Agency mortgage-related securities	77,289	6	83,707	6
Non-agency mortgage-related securities	114,772	8	78,392	6
Total non-Freddie Mac mortgage-related securities	192,061	14	162,099	12
Mortgage loans	60,270	4	63,886	5
Total Retained portfolio(5)	645,466	46	567,272	43
PCs and Structured Securities in the Cash and investments portfolio(4)(6)	16,769	1	19,528	2
Total mortgage portfolio	$1,414,399	100%	$1,316,609	100%
Total PCs issued and Structured Securities(7)(8)	$1,162,068		$1,090,624	

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

(2) Due to the nature of security program remittance cycles of PCs and Structured Securities, the unpaid principal balances of the underlying mortgage loans do not always equal the unpaid principal balance of issued PCs and Structured Securities. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Due to Participation Certificate Investors" to the consolidated financial statements for more information.

(3) Represents PCs and Structured Securities that are held by third parties.

(4) Subsequent to the announcement of our 2003 financial results in our Information Statement Supplement dated June 30, 2004, we revised the balance of PCs and Structured Securities in the Cash and investments portfolio due to a calculation error. The effect of this change was a $584 million decrease in PCs and Structured Securities in the Cash and investments portfolio at December 31, 2002 and a corresponding increase in Outstanding PCs and Structured Securities. The consolidated financial statements were not affected by this revision.

(5) The Retained portfolio presented in this table differs from the Retained portfolio presented in our consolidated balance sheets because the consolidated balance sheet caption includes valuation adjustments (*e.g.*, fair value adjustments for securities classified as available for sale and trading and the Reserve for losses on mortgage loans held for investment) and deferred balances (*e.g.*, premiums and discounts). "Table 2 — Reconciliation of Retained Portfolio Unpaid Principal Balances to the Consolidated Balance Sheets" below provides a reconciliation of the Retained portfolio amounts shown in this table to the amounts shown under such caption in accordance with GAAP on our consolidated balance sheets.

(6) Represents PCs and Structured Securities we hold in connection with PC market-making and support activities, which are reflected in Investments on our consolidated balance sheets.

(7) As further discussed in "NOTE 4: FINANCIAL GUARANTEES" to the consolidated financial statements, these amounts include:

- $4,729 million and $8,561 million of Structured Securities backed by Ginnie Mae Certificates at December 31, 2003 and 2002, respectively.
- $5,044 million and $4,643 million at December 31, 2003 and 2002, respectively, that pertain to our guarantee of the payment of principal and interest on (a) tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties and (b) multifamily mortgage loans that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds.
- $2,278 million and $–0– at December 31, 2003 and 2002, respectively, of single-family mortgage loans held by third parties for which we provided a credit guarantee.

(8) PCs and Structured Securities (including single-class and multi-class securities, as defined in "Table 3 — Freddie Mac Single-Class and Multi-class PCs and Structured Securities Based on Unpaid Principal Balances") exclude $637,491 million and $752,671 million at December 31, 2003 and 2002, respectively, of Structured Securities where we have resecuritized PCs and other previously issued Structured Securities. These excluded Structured Securities do not increase our credit related exposure and consist of single-class Structured Securities backed by PCs, Real Estate Mortgage Investment Conduits, or REMICs and principal-only strips. The notional balance of interest-only strips of $91,192 million and $113,654 million at December 31, 2003 and 2002, respectively, is excluded because this table is based on unpaid principal balances. Also excluded are modifiable and combinable REMIC tranches and Interest and Principal classes, which collectively totaled $988,600 million and $1,301,666 million at December 31, 2003 and 2002, respectively, where the holder has the option to exchange the security tranches for other pre-defined security tranches. See "Resecuritization" for more information on Structured Securities.

Table 2 provides a reconciliation of the Retained portfolio unpaid principal balances to the amount shown on our consolidated balance sheets.

Table 2 — Reconciliation of Retained Portfolio Unpaid Principal Balances to the Consolidated Balance Sheets

	December 31,	
	2003	2002
	(dollars in millions)	
Mortgage loans in the Retained portfolio:		
Unpaid principal balances	$ 60,270	$ 63,886
Premiums, discounts, deferred fees and other basis adjustments[1]	64	232
Less: Reserve for losses on mortgage loans held for investment	(174)	(177)
Mortgage loans, net of reserve per consolidated balance sheets	60,160	63,941
Mortgage-related securities in the Retained portfolio:[2]		
Unpaid principal balances[3]	585,196	503,386
Premiums, discounts, deferred fees and other basis adjustments[4]	4,729	3,463
Net unrealized gains on mortgage-related securities	9,601	18,520
Participation Certificate residuals at fair value	671	412
Mortgage-related securities per consolidated balance sheets	600,197	525,781
Total Retained portfolio per consolidated balance sheets	$660,357	$589,722

(1) Other basis adjustments primarily relate to valuation adjustments for loans held for sale, as well as basis adjustments related to hedging activities. Basis adjustments are modifications to the carrying value of these mortgage loans.
(2) Includes PCs, Structured Securities and non-Freddie Mac mortgage-related securities.
(3) Includes other-than-temporary impairments of certain securities. Impairments to unpaid principal balances are recorded in certain circumstances when the fair value declines below the amortized cost basis of a security.
(4) Other basis adjustments are related to hedging activities, certain impairments related to interest-only securities and the Day One Differences (as defined in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements) that correspond to PCs and Structured Securities that we purchase. Basis adjustments are modifications to the carrying value of these securities.

Our Cash and investments portfolio, which primarily consists of non-mortgage-related securities, is not included in our Retained portfolio. Our Cash and investments portfolio includes investments we acquire to manage recurring cash flows, provide a source of liquidity, temporarily deploy capital until the capital can be redeployed into Retained portfolio investments and manage interest-rate risk exposure. The Cash and investments portfolio also includes certain mortgage-related securities, which are not included in the Retained portfolio since they are held in conjunction with our PC market-making and support activities.

For information regarding the sources of our revenues and net income, including derivative and investment gains (losses) and expenses, see "MD&A — CONSOLIDATED RESULTS OF OPERATIONS."

Market Overview

We conduct business in the U.S. residential mortgage market and the global securities market. Our participation in these markets links America's homebuyers with the world's capital markets. Total U.S. residential mortgage debt outstanding exceeded $7.7 trillion and $6.8 trillion at December 31, 2003 and 2002, respectively. Mortgage debt outstanding has grown every year since the end of World War II and grew at a 13 percent rate in 2003 and a 12 percent rate in 2002, even though some other indicators of economic growth slowed during these same periods.

In general terms, the U.S. residential mortgage market consists of a primary mortgage market that links homebuyers and lenders, and a secondary mortgage market that links lenders and investors. In the primary market, residential mortgage lenders such as mortgage banking companies, commercial banks, savings institutions and credit unions originate or provide mortgages to borrowers. They obtain the funds they lend to

mortgage borrowers in a variety of ways, including selling mortgages into the secondary market. Our charter does not permit us to originate loans in the primary mortgage market.

The secondary market consists of institutions engaged in buying and selling mortgages in the form of whole loans (*i.e.,* mortgages that have not been securitized) and mortgage-related securities. The magnitude of investment and trading activity in the secondary mortgage market supports a continuous flow of funds to the primary market. This stable flow of funds helps moderate cyclical swings in the housing market and provides for mortgage funds to be available at all times.

Various other participants also play significant roles in the residential mortgage market. Mortgage brokers advise prospective borrowers about mortgage products and lending rates, and they connect borrowers with lenders. Mortgage servicers administer mortgage loans by collecting payments of principal and interest from borrowers as well as amounts related to property taxes and insurance. Mortgage servicers remit the principal and interest payments to us, less a servicing fee, and for mortgages we have securitized, we pass these payments through to mortgage investors, less a fee we charge to guarantee the payment of principal and interest and administer payments. The servicing fee charged by mortgage servicers varies by mortgage product. As of December 31, 2003, the required minimum percentage fee typically retained by our single-family servicers was 0.25 percent of the unpaid principal balance of the mortgage loans. Mortgage servicers also help us manage our loss mitigation and foreclosure process for mortgages that we own or guarantee. In addition, private mortgage insurance companies and other financial institutions sometimes provide third-party insurance for mortgage loans or pools of loans. Our charter requires third-party insurance or other credit protections on some loans that we purchase.

Freddie Mac and Fannie Mae are the largest participants in the U.S. secondary mortgage market. Freddie Mac and Fannie Mae are both GSEs with the public purpose of increasing the supply and availability of home mortgage financing. As discussed below, our statutory mission requires us to participate in the conforming mortgage market at all times. By contrast, non-GSE market participants are free to enter and exit the mortgage market as part of business strategies that allow them to pursue multiple lines of business in a variety of economic conditions.

Freddie Mac and Fannie Mae have charters that prohibit them from originating mortgage loans and limit them to purchasing mortgages with original principal balances at or below prescribed dollar limits. These limits are referred to as conforming loan limits and are subject to annual adjustment based on an index of national average house prices and in accordance with a procedure established by OFHEO. The conforming loan limit for a first-lien conventional single-family mortgage in 2003 was $322,700 for a one-family residence, $413,100 for a two-family residence, $499,300 for a three-family residence and $620,500 for a four-family residence. For 2004, the conforming loan limit is $333,700 for a one-family residence, $427,150 for a two-family residence, $516,300 for a three-family residence and $641,650 for a four-family residence. The conforming loan limit for second-lien mortgages on one-family residences is 50 percent of the limit for first-lien mortgages on such residences. When we purchase both the first-lien and second-lien mortgage on the same property, the total amount that we purchase may not exceed the applicable conforming first-lien loan limit. The applicable conforming loan limits are 50 percent higher for mortgages secured by properties in Alaska, Guam, Hawaii and the U.S. Virgin Islands. No comparable limits apply to multifamily mortgage purchases.

The Freddie Mac Act also prohibits us from purchasing first-lien conventional (that is, not guaranteed or insured by any agency or instrumentality of the U.S. government) single-family mortgages if the outstanding principal balance at the time of purchase exceeds 80 percent of the value of the property securing the mortgage, unless we have one or more of the following credit protections: mortgage insurance from an approved mortgage insurer; a seller's agreement to repurchase or replace (for periods and under conditions as we may determine) any mortgage in default; or retention by the seller of at least a ten percent participation interest in the mortgages. This requirement does not apply to multifamily mortgages or to mortgages insured by the Federal Housing Administration, or FHA, or partially guaranteed by the Department of Veterans Affairs, or VA.

Under the Freddie Mac Act, so far as practicable, we may only purchase mortgages that are of a quality, type and class that generally meet the purchase standards of private institutional mortgage investors. This means the mortgages we purchase must be readily marketable to institutional mortgage investors.

While we compete in the secondary mortgage market primarily with Fannie Mae, we also compete with other financial institutions that retain or securitize mortgages, such as banks, dealers and thrift institutions, and with the Federal Home Loan Banks. Competition from these entities can vary with economic, financial market and regulatory environments. Among other things, these factors may affect the degree to which depository and other institutions sell mortgages in the secondary market rather than retain them in their own portfolios.

During 2003, we estimate that approximately $2.8 trillion of conventional, conforming single-family mortgages were originated in the U.S. and that Freddie Mac and Fannie Mae purchased 25 percent and 42 percent of that amount, respectively. During 2002, we estimate that approximately $2.0 trillion of conventional, conforming single-family mortgages were originated in the U.S. and that Freddie Mac and Fannie Mae purchased 26 percent and 32 percent of that amount, respectively. The relatively high market share of Freddie Mac and Fannie Mae resulted from the high level of refinance activity in 2003 and 2002 as a consequence of declining interest rates and a strong demand for fixed-rate mortgage products, which loan originators tend to deliver to Freddie Mac and Fannie Mae.

We also compete in the global securities market as an issuer of mortgage-related and debt securities. Our securities have a number of attributes that help us operate efficiently and on a large scale in both our mortgage securitization and debt financing activities. These attributes include the high credit quality and liquidity of our securities. They also include legal attributes under our charter and other federal laws and regulations. These legal attributes, which facilitate our development and maintenance of the liquid markets that are essential to fulfilling our Congressional mandate, are described in "Regulation and Governmental Relationships — *Legislative Matters* — Congressional Charter" below.

Our purchases of mortgage loans and issuances of mortgage-related and debt securities may be affected by a variety of legislative and regulatory actions related to the activities of banks, savings institutions, insurance companies, securities dealers and other regulated entities that comprise a significant part of our customer base. Among the legislative and regulatory provisions applicable to these entities are:

- Regulatory capital requirements for federally insured depository institutions and regulated bank holding companies; for example, the Basel Committee on Banking Supervision, composed of representatives of certain central banks and bank supervisors, is developing a new set of risk-based capital standards for banking organizations. The U.S. banking regulators have proposed to adopt the new capital standards for certain banking organizations by January 1, 2007 and have solicited public comments regarding the manner of such implementation. If final rules adopted by the U.S. banking regulators revise the treatment of mortgage assets, decisions by U.S. banking organizations about whether to hold or sell such assets could be affected. However, the contents and timing of any final rules remain uncertain, as does the manner in which U.S. banking organizations may respond to them.

- Limitations on investments by federally insured depository institutions in certain types of mortgage securities; and

- Legislation and regulations regarding the subprime lending activities of federally insured depository institutions.

To the extent that legislative or regulatory provisions create or remove incentives for these entities either to sell mortgage loans to us or to purchase our securities, they could have a material effect on our business results.

Mortgage Purchase and Guarantee Activity

We purchase single-family mortgages mainly from mortgage bankers, dealers, insurance companies and federally insured financial institutions. We purchase multifamily mortgages from mortgage lenders, including federally insured financial institutions, mortgage bankers, investment bankers and insurance companies.

Our single-family mortgage products, services and initiatives are designed to provide a steady source of low-cost mortgage funding to America's homebuyers. Our multifamily mortgage products, services and initiatives are designed primarily to finance rental housing affordable to low- and moderate-income families.

A significant portion of our single-family mortgage purchase volume is generated from several large mortgage lenders. During 2003, Wells Fargo Home Mortgage, Inc., ABN Amro Mortgage Group, Inc., Principal Residential Mortgage Inc., and Chase Manhattan Mortgage Corporation together accounted for approximately 58 percent of our mortgage volume. Wells Fargo was the largest source and accounted for approximately 33 percent of our mortgage purchase volume in 2003, while ABN Amro, our second largest source, accounted for approximately 12 percent of our mortgage purchase volume. We have contracts with some of these lenders that include a commitment by the lender to sell us a minimum share or dollar amount of its conventional conforming mortgage origination volume. Because the typical length of these contracts is one year, some of the contracts may expire in close proximity to each other at any given time. We actively monitor these lenders' share volume and if a mortgage lender fails to meet its contractual commitment, we have a variety of contractual protections, including the assessment of certain fees.

We are exposed to the risk that we will lose significant business volume and will be unable to replace this business if one or more of these key lenders chooses to significantly reduce the volume of mortgages it delivers to us or if a lender ceases to exist because of a merger or an acquisition. For example, in 2003, one mortgage lender that has historically provided us with significant business volume, Bank of America, N.A., substantially reduced its deliveries to us. In addition, Principal Residential Mortgage Inc., one of our top mortgage lenders, was acquired by Citigroup Inc. in 2004. The loss of any one of our key lenders could adversely affect our market share, our revenues, the use of our technology by participants in the mortgage market and the performance of our mortgage-related securities. We believe that we would be able to recover from a significant decrease in, or loss of, business volume from one or more of our largest customers, through such means as strengthening our relationships with other major lenders and servicers or modifying our business strategies. This anticipated recovery, however, might not occur quickly or at all.

Single-Family Mortgages

Single-family mortgages are mortgages secured by one- to four-family properties. We purchase single-family mortgages of various types, including 30-year, 20-year, 15-year and 10-year fixed-rate mortgages, adjustable-rate mortgages, or ARMs, and balloon/reset mortgages. The substantial majority of the mortgages we purchase are conventional mortgages. However, we purchase some mortgages that are fully insured by the FHA and the Rural Housing Services, or RHS, and some mortgages that are partially guaranteed by the VA.

Single-family mortgages generally are subject to our internal credit policies and the credit, appraisal, underwriting and other purchase policies and guidelines incorporated into Loan Prospector® (our automated underwriting system) and set forth in our *Single-Family Seller/Servicer Guide*. However, we may modify or grant waivers to these policies and guidelines.

Multifamily Mortgages

We purchase multifamily mortgages, which are secured by structures with five or more units designed principally for residential use, with terms generally ranging from five to 30 years from approved lenders. We have established multifamily mortgage credit, appraisal and underwriting guidelines as set forth in our internal credit policies and our *Multifamily Seller/Servicer Guide*. We may modify these guidelines or grant waivers for some multifamily mortgages when compensating factors (such as higher debt coverage ratios or credit enhancements) are present.

Credit Guarantee

We typically assume the mortgage credit risk on mortgages underlying PCs by guaranteeing the payment of principal and interest to PC holders. We manage this risk carefully, sharing the risk in some cases with third parties through the use of primary loan-level mortgage insurance, insurance on pools of mortgage loans (known as "pool insurance") and other credit enhancements. See "MD&A — RISK MANAGEMENT — Credit Risk" for more information.

As we expand our business activities in the affordable housing sector of the mortgage market in support of our statutory mission, we anticipate that some of the mortgages we will purchase through these activities may present a higher risk of default loss than the mortgages we purchased in previous years. We expect to utilize our experience in mortgage underwriting and credit risk assessment to manage this increased risk effectively. Additions made to date to the scope of our mortgage purchases in the affordable housing sector are not expected to materially increase credit losses above the range generally assumed in pricing our mortgage purchases. We believe that if the U.S. Department of Housing and Urban Development, or HUD, adopts revised affordable housing goals as it has proposed, or if market conditions reduce the percentage of our routine mortgage purchases that are goal-eligible, these factors could adversely affect our future results of operations, due to increased credit losses on purchases of goal-qualifying mortgages, less favorable pricing of such purchases, or reduced purchases of non-goal-qualifying mortgages. See "Regulation and Governmental Relationships — *Regulatory Matters.*"

We form PCs under our Mortgage Participation Certificates Agreement, which we refer to as the PC Agreement, among Freddie Mac and the holders of our PCs. The PC Agreement describes the manner in which mortgages are transferred to a pool and, upon issuance of a PC, an undivided interest in the mortgages in the pool is conveyed to the holder of the PC. The PC Agreement also describes our obligations as guarantor of principal and interest on the PCs, and the manner in which those payments are passed through to the PC holders. In addition, the PC Agreement describes the rights of the PC holders in the event of our default. Once mortgages are placed in a pool, the mortgages cannot be removed from the pool except in limited circumstances specified in the PC Agreement. We generally begin a process to repurchase defaulted mortgages when they have been identified as being delinquent for 120 consecutive days. We then hold these repurchased mortgages in our Retained portfolio. In order to manage and resolve troubled assets and lower credit losses, we utilize a number of loss mitigation strategies, which emphasize early intervention in delinquent mortgages and alternatives to foreclosure. See "MD&A — RISK MANAGEMENT — Credit Risk — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies — *Loss Mitigation Activities*" for more information.

OFHEO is our safety and soundness regulator. If we were to experience significant financial difficulties and the Director of OFHEO were to appoint a conservator, we believe, based on an opinion of counsel analyzing various provisions in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, or the GSE Act, and other relevant law, that the proportional undivided interests of the PC holders would be preserved and borrowers' payments and other recoveries on the mortgage loans would continue to be passed through to the PC holders. Payments due to PC holders pursuant to our guarantees could be made only from our general funds to the extent and so long as they were available. If we were unable to meet our guarantee obligations, the primary sources of funds available to investors would be payments by mortgage borrowers and recoveries related to properties securing the mortgage loans. In that case, payments to the PC holders could be adversely affected by loan delinquencies and defaults. See "Regulation and Governmental Relationships" for more information about OFHEO.

The profitability of our credit guarantee activities and our ability to compete for mortgage purchases and guarantee business tend to be affected, and may be affected significantly, by the price difference, or spread, between our PCs and competing securities, primarily those issued by Fannie Mae. See "PC Market-Making and Support Activities" for more information. Other key factors affecting the profitability of credit guarantee activities include credit-related expenses, the costs incurred to administer PC pools, and timing differences in our receipt of principal and interest payments from mortgage servicers and the subsequent pass through of payments to PC investors, which we refer to as "security program cycles."

The To Be Announced Market

Most of the PCs we issue represent pools of mortgages that have similar characteristics – such as PCs comprising 30-year fully amortizing fixed-rate mortgages with mortgage coupons within a specified range. Because these PCs are homogeneous and are issued in high volume, they are highly liquid and trade on a "generic" basis, also referred to as trading in the To Be Announced, or TBA, market. A TBA trade represents a contract for the purchase or sale of PCs to be delivered at a future agreed-upon date; however, the specific PCs, and thus the specific characteristics of the mortgages underlying those PCs, that will be delivered to fulfill the trade obligation are not known (*i.e.*, "announced") at the time of the trade, but only subsequently when the trade is to be settled.

Any two (or more) market participants may be involved as parties to a TBA trade. Counterparties to a particular trade may include: mortgage originator to dealer, dealer to dealer, dealer to investor, institution to institution, or parties dealing through an electronic trading system – anonymous or not. While the majority of TBA trades are performed manually, with purchases and sales occurring through direct contact between or among the parties to the trade, broker-dealers often trade as anonymous participants through an inter-dealer broker or electronic trading system.

Purchases and sales of TBA-eligible PCs occur daily. Prices are generally quoted and accepted based only upon the name of the issuer (*e.g.*, Freddie Mac), the type of PC (*e.g.*, 30-year fixed rate), the coupon of the PC, the quantity and the settlement month, all of which is similar to the manner in which U.S. Treasury securities are quoted. Each type of TBA trade has a single designated settlement date in each month, and 48 hours before the settlement date the parties identify the specific PCs to be delivered to fulfill the TBA trade obligation. During 2003 and 2002, we issued approximately $564 billion and $434 billion, respectively, of PCs that were eligible to be delivered to settle TBA trades, representing approximately 80 percent and 81 percent, respectively, of our total PC issuances.

Lenders use the TBA market to hedge the risk of changes in the fair value of mortgage loans caused by fluctuations in mortgage interest rates that occur after the lender "locks in" a mortgage interest rate with a borrower, but before the mortgage loan is originated. When a lender locks in a rate for a borrower, the lender may sell PCs in the TBA market. After the lender originates the mortgages, it delivers the mortgages to us in a swap transaction and receives PCs in return. Those PCs can then be used to settle the TBA trade, or the lender can settle the trade with any of our other existing PCs that meet the generic terms of the trade.

We also use the TBA market to hedge cash transactions. When a lender commits to deliver mortgages to us in exchange for cash at a specified price, we may sell PCs in the TBA market for delivery at a future date. By using the TBA market, we can hedge the risk of fluctuations in interest rates by locking in the price at which we will sell the PCs that will ultimately be formed from the mortgages we purchase from lenders in cash transactions.

These uses of the TBA market by lenders, dealers, investors and us increase the liquidity of mortgage investments and improve the distribution of investment capital available for residential mortgage financing, thereby helping us to accomplish our statutory mission.

Resecuritization

We resecuritize PCs and non-Freddie Mac mortgage-related securities into single-class and multi-class Structured Securities. We also resecuritize Structured Securities into other Structured Securities.

Single-Class Structured Securities

We issue single-class Structured Securities backed by PCs and by non-Freddie Mac mortgage-related securities, including Ginnie Mae Certificates.

Multi-Class Structured Securities

We issue multi-class Structured Securities that divide the cash flows of the underlying PCs or non-Freddie Mac mortgage-related securities, including Ginnie Mae Certificates and non-agency mortgage-related securities, into two or more classes that meet the investment criteria and portfolio needs of different types of

investors. The non-agency mortgage-related securities may be backed by mortgages originated using underwriting standards that are less stringent than our normal criteria; however, these securities are significantly credit-enhanced at issuance. By issuing Structured Securities backed by these securities, we seek to provide liquidity to alternative segments of the mortgage market. See "MD&A — RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies — *Portfolio Diversification"* for more information concerning the additional credit risk related to these transactions.

Our principal multi-class Structured Securities activity is the issuance and sale of securities that qualify for tax treatment as REMICs. A multi-class Structured Security may include short-, intermediate-, and long-term classes that are paid different allocations of principal and interest from the underlying PCs or other securities according to specified criteria (such as principal-only strips, interest-only strips, or securities with fixed- or variable-rate coupons) and residual classes that receive any cash flow not required to be distributed to the other classes of the REMIC. Some multi-class Structured Securities are structured to provide investors with more predictable cash flows than a typical PC, while other multi-class Structured Securities generate less predictable cash flows.

The issuance of multi-class Structured Securities backed directly or indirectly by PCs improves the demand for, and value of, PCs and ultimately reduces mortgage rates. Issuing multi-class Structured Securities generally does not generate additional management and guarantee income for us or expose us to additional credit risk. We typically collect a fee upon the formation of each multi-class Structured Security based on the dollar amount and type of structure issued. We may purchase previously issued multi-class Structured Securities for our Retained portfolio. Some of the multi-class Structured Securities in our Retained portfolio are less liquid than PCs. Consequently, it may be more difficult to sell these assets at their estimated fair value as a result of the comparatively large bid/ask spreads that arise due to the relative liquidity of these multi-class Structured Securities. We also issue multi-class Structured Securities, which may be backed by PCs or other securities contributed by our Retained portfolio, with the intent of purchasing and retaining one or more classes that meet our portfolio investment needs and selling the other classes.

Table 3 — Freddie Mac Single-Class and Multi-Class PCs and Structured Securities Based on Unpaid Principal Balances[1]

	December 31, 2003			
	PCs and Structured Securities in Retained Portfolio	PCs and Structured Securities in Cash and Investments Portfolio[2]	PCs and Structured Securities Outstanding (held by third parties)	Total PCs and Structured Securities Issued
	(dollars in millions)			
PCs and Structured Securities:				
Single-class[3]	$269,442	$15,970	$397,009	$ 682,421
Multi-class[4][5]	123,693	799	347,833	472,325
Other[6]	—	—	7,322	7,322
Total PCs and Structured Securities	$393,135	$16,769	$752,164	$1,162,068

	December 31, 2002			
	PCs and Structured Securities in Retained Portfolio	PCs and Structured Securities in Cash and Investments Portfolio[2]	PCs and Structured Securities Outstanding (held by third parties)	Total PCs and Structured Securities Issued
	(dollars in millions)			
PCs and Structured Securities:				
Single-class[3]	$203,538	$17,893	$332,621	$ 554,052
Multi-class[4][5]	137,749	1,635	392,545	531,929
Other[6]	—	—	4,643	4,643
Total PCs and Structured Securities	$341,287	$19,528	$729,809	$1,090,624

(1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
(2) Represents PCs and Structured Securities held by us in connection with PC market-making and support activities, which are reflected in Investments on our consolidated balance sheets.
(3) Includes PCs that do not back Structured Securities and single-class Structured Securities backed by Ginnie Mae Certificates.
(4) Includes Structured Securities backed by PCs, Structured Securities backed by non-Freddie Mac mortgage-related securities and multi-class Structured Securities backed by Ginnie Mae Certificates.
(5) Excludes $42,692 million and $18,423 million at December 31, 2003 and 2002, respectively, of total multi-class Structured Securities where we have resecuritized other already issued Structured Securities.
(6) As further discussed in "NOTE 4: FINANCIAL GUARANTEES" to the consolidated financial statements, these amounts include:
- $4,729 million and $8,561 million of Structured Securities backed by Ginnie Mae Certificates at December 31, 2003 and 2002, respectively.
- $5,044 million and $4,643 million at December 31, 2003 and 2002, respectively, that pertain to our guarantee of the payment of principal and interest on (a) tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties and (b) multifamily mortgage loans that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds.
- $2,278 million and $-0- at December 31, 2003 and 2002, respectively, of single-family mortgage loans held by third parties for which we provided a credit guarantee.

Portfolio Investment

We manage a large and diversified retained mortgage portfolio through a disciplined strategy of long-term capital deployment. We apply extensive mortgage-market expertise and a deep understanding of this asset class to support prudent and timely asset selection while managing our interest-rate risk. We invest in mortgage-related securities issued by GSEs or governmental agencies, which we refer to as agency securities, non-agency mortgage-related securities and whole mortgage loans. For information concerning the types of securities we purchase and hold as well as the volume of our purchases and balances held in our Retained portfolio by security type, see "MD&A — VOLUME STATISTICS" and "MD&A — RISK MANAGEMENT — Credit Risks."

We issue debt principally to finance our purchases of mortgage-related securities and mortgage loans for our Retained portfolio. We manage interest-rate risk and reduce funding cost by:

- Issuing a mixture of debt of various maturities, either callable (that is, redeemable at our option at one or more times before its scheduled maturity) or non-callable. We use this funding mix to manage our interest-rate risk through the flexibility to closely match the interest obligations on our debt with the expected cash inflows from our mortgage-related investments;
- Using a variety of derivatives. See "MD&A — RISK MANAGEMENT — Interest-Rate and Other Market Risks" for more information; and

- Restructuring mortgage-related securities cash flows, and retaining a portion of these restructured cash flows as Structured Securities.

Our Retained portfolio (based on unpaid principal balances) grew by 14 percent during both 2003 and 2002.

Debt Securities

We issue short-, medium- and long-term debt; and subordinated debt.

Short-Term Debt. We raise funds to meet our operating cash needs primarily through the issuance of Reference Bills® securities and other discount notes, which are short-term instruments with maturities of one year or less that are sold on a discounted basis, paying only principal at maturity. Our Reference Bills® program consists of large issues of short-term debt that we auction to dealers through the Internet on a regular schedule. We currently auction Reference Bills® with 1-, 3- and 6-month maturities weekly. Prior to 2004, we also auctioned Reference Bills® with 2-month maturities weekly. We auction Reference Bills® with 12-month maturities every four weeks. We issue discount notes with maturities ranging from one day to one year in response to investor demand and our cash needs.

Medium- and Long-Term Debt. We issue medium- and long-term debt primarily through our medium-term note program and our global debt facility. Each of these programs accommodates a variety of structures, including callable and non-callable fixed-rate securities, zero coupon securities and variable-rate securities. Through our Reference Notes® securities program, we sell large issues of medium- and long-term debt that provide investors worldwide with a high-quality, liquid investment vehicle. Some of our Reference Notes® are sold through Internet auctions. We primarily issue securities denominated in U.S. dollars, although we may issue securities denominated in various other currencies, particularly Euros. We publish an annual financing calendar that is intended to provide clarity and transparency with regard to the timing of our offerings of Reference Notes® and settlement dates for issuances.

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

Subordinated Debt. In October 2000, we announced plans to initiate periodic issuances of subordinated debt securities, which we refer to as Freddie SUBS® securities, as part of a series of voluntary commitments regarding our financial operations and disclosures designed to further strengthen our transparency, capital adequacy and market discipline. During 2001 and 2002, we completed four offerings of Freddie SUBS® that provided approximately $5.5 billion in net proceeds. During 2003, we did not issue any Freddie SUBS®. Our ability to issue subordinated debt may be limited until we return to timely financial reporting. See "MD&A — LIQUIDITY AND CAPITAL RESOURCES," "MD&A — VOLUNTARY COMMITMENTS" and our Internet website (www.FreddieMac.com/investors) for additional information about our voluntary commitments.

PC Market-Making and Support Activities

We make markets in agency mortgage-related securities by distributing these securities to, and trading these securities with, various counterparties, including mortgage sellers, institutional investors and securities dealers. We manage and conduct these trading activities primarily through our Securities Sales and Trading Group, or SS&TG, business unit. SS&TG buys, sells and exchanges our PCs and Structured Securities, as well as Fannie Mae and Ginnie Mae mortgage-related securities, in various financial transactions (including forward sales, dollar rolls and reverse repurchase transactions). SS&TG transacts in such securities in large volumes to ensure competitiveness in the mortgage-related securities market, to have a positive impact on the liquidity of Freddie Mac PCs and Structured Securities and to contribute to corporate profitability. SS&TG also regularly purchases mortgage-related securities on behalf of our Retained portfolio. This sourcing activity builds upon SS&TG's daily purchases of mortgage-related securities through its direct trading relationships with mortgage sellers and investors. As part of these relationships, SS&TG also provides services to assist

mortgage sellers and investors in the execution of transactions involving mortgage loans and mortgage-related securities. In conjunction with our PC market-making and support activities, SS&TG often holds mortgage-related securities in its trading portfolio. Gains and losses related to SS&TG's investment activities are reflected in Gain (loss) on investment activities while the net interest income related to SS&TG's investments is included in Net interest income on our consolidated statements of income. SS&TG's assets are included in the Cash and investments portfolio on our consolidated balance sheets.

We manage market risks associated with SS&TG's securities positions primarily through forward purchases and sales of PCs and Structured Securities, as well as through the purchase and sale of mortgage pass-through securities of Fannie Mae and Ginnie Mae. To accomplish this objective, we also may use U.S. Treasury securities, agency debt securities, Eurodollar futures and options to buy or sell agency debt and mortgage-related securities. To manage institutional credit risk, SS&TG analyzes and monitors the financial condition and trading positions of all counterparties and establishes trading limits consistent with these reviews.

SS&TG also assists in the distribution of PCs and Structured Securities to institutional investors and other market participants. Distribution activities may include participation in dealer auctions of these securities, resecuritization of outstanding PCs and Structured Securities, participation in dealer syndicates for underwritten offerings of Structured Securities and other transactions.

Mortgage Security Performance and Other Market Support Activities

We support the liquidity and depth of the market for PCs through various activities, including:

- Actively trading PCs through SS&TG;
- Participating with external money managers to buy and sell PCs;
- Marketing to dealers and investors the relative merits of trading and investing in PCs;
- Purchasing and selling PCs through the Retained portfolio; and
- Introducing new mortgage-related securities products and initiatives.

We may increase, reduce or discontinue these or other related activities at any time, which could affect the liquidity and depth of the market for our PCs. We support the execution of our credit guarantee business by making guarantee fee trade-offs with sellers. If the price performance of, and demand for, our PCs is not comparable to Fannie Mae securities on future mortgage deliveries by sellers, we may use market-adjusted pricing where we provide guarantee fee price adjustments to partially offset weaknesses in prevailing security prices in order to increase the competitiveness of our credit guarantee business. The use of market-adjusted pricing could have a material adverse effect on the profitability of our new credit guarantee business.

Our strategies to support PC price performance in 2003 included the purchase by our Retained portfolio of TBA PCs and both the purchase and sale of other agency securities, including the sale of Fannie Mae securities. While some purchases of PCs may result in an expected return on equity substantially below our normal thresholds, this strategy is not currently expected to have a material effect on the performance of our Retained portfolio overall. Depending upon market factors and trends, including the relative prices and supply of PCs and comparable Fannie Mae securities in accordance with this strategy, there may be substantial variability in any period of the total amount of TBA PCs the Retained portfolio purchases and of other agency securities the Retained portfolio purchases or sells.

Regulation and Governmental Relationships

Legislative Matters

Congressional Charter

Our Congressional charter provides us with special attributes such as:

- Exemption from Securities Act and Exchange Act registration requirements (although we are subject to the antifraud provisions of those laws and are committed to the voluntary registration of our common stock with the SEC under the Exchange Act);
- Favorable treatment of our securities under various legal investment laws and other regulations;
- Access to the Federal Reserve Banks' book-entry system, which provides book-entry issuance, transfer, payment and settlement for our mortgage-related and debt securities;
- Discretionary authority of the Secretary of the Treasury to purchase obligations issued by us up to a maximum of $2.25 billion principal balance outstanding at any one time; and
- Exemption from state and local taxes, except tax on real property that we own.

These special attributes, combined with our financial strength and the efficiency we bring to the market, help us to develop and maintain the liquid markets that are essential to fulfilling our Congressional mandate.

We could be required, or may find it advisable, to change the nature or extent of our business activities if our various exemptions and special attributes were modified or eliminated, new or additional fees or substantive regulation of our business activities were imposed, our relationship to the federal government were altered or eliminated, or the Freddie Mac Act, the GSE Act or other federal legislation affecting us were significantly amended. Any of these changes could have a material adverse effect on the scope of our activities, financial condition and results of operations. Any amendments to the Freddie Mac Act or the GSE Act, including repeal of any of our exemptions, would require legislative action. In addition, our business also could be adversely affected by any modification, reduction or repeal of the federal income tax deductibility of mortgage interest payments.

GSE Regulatory Oversight Legislation

The Senate Banking Committee passed a GSE regulatory oversight bill on April 1, 2004. Freddie Mac believes that the Senate is unlikely to take further action on this bill in 2004. We also believe that it is unlikely that the House of Representatives will consider GSE regulatory oversight legislation in 2004. Both the House and the Senate have indicated that they are likely to consider GSE regulatory oversight legislation in the next session of Congress. Freddie Mac strongly supports enactment of legislation to strengthen the GSE regulatory structure. We will continue to work with the Congress, the Administration and other interested parties toward enacting appropriate regulatory oversight legislation.

Regulatory Matters

We are currently subject to oversight by:

- HUD; and
- OFHEO, a separate office within HUD created by the GSE Act.

In addition, the U.S. Department of the Treasury has the authority to approve our issuances of debt and mortgage-related securities as discussed below.

See "Voluntary SEC Reporting" below for information concerning the SEC's future oversight of us.

HUD. HUD has general regulatory power over us. HUD's oversight to date has focused upon three main areas: housing goals, fair lending and new program approval.

Housing Goals. The GSE Act requires the Secretary of HUD to establish three goals related to our financing of:

- Housing for low- and moderate-income families, which we refer to as the Low- and Moderate-Income Goal;
- Housing located in central cities, rural areas and other underserved areas, which we refer to as the Underserved Areas Goal; and
- Housing for low-income families in low-income areas and for very-low-income families, including a dollar amount for multifamily housing, which we refer to as the Special Affordable Goal.

We seek to purchase most single-family and multifamily mortgages that qualify under one or more of the affordable housing goals through our standard mortgage purchase programs and under the same credit standards as our other mortgage purchases. In October 2000, the Secretary of HUD issued final regulations establishing affordable housing goals for us and Fannie Mae for calendar years 2001 through 2003, which increased the affordable housing goals in place relative to calendar years 1997 through 2000. The final rule increased the Low- and Moderate-Income Goal from the previous 42 percent of mortgage purchases to 50 percent; the Underserved Areas Goal from the previous 24 percent of mortgage purchases to 31 percent; and the Special Affordable Goal from the previous 14 percent of mortgage purchases to 20 percent, including an increase in the target for qualifying multifamily mortgage purchases from the previous $0.99 billion to $2.11 billion.

We have reported to HUD that we achieved each of the goals in 2003 and 2002. Our purchases, as counted under HUD's regulations, are set forth in "Table 4 — Housing Goals" below. On April 27, 2004 and May 7, 2004, we received letters from the House of Representatives Committee on Financial Services requesting information pertaining to certain transactions entered into in whole or in part for the purpose of meeting the affordable housing goals for calendar years 2001, 2002 and 2003. In addition, on May 4, 2004 and August 3, 2004, we received letters from HUD requesting information pertaining to certain transactions entered into in calendar years 2001, 2002 and 2003. As part of the information request, HUD asked us to describe how each identified transaction complies with HUD's rules for counting units financed in each transaction toward the housing goals in 2003, 2002 and 2001. We fully complied with these requests for information.

Table 4 — Housing Goals

	Year Ended December 31,			
	2003		2002	
	Goal	Result	Goal	Result
Low- and moderate-income goal	50%	51%	50%	51%
Underserved areas goal	31	33	31	32
Special affordable goal	20	20	20	21
Multifamily special affordable volume goal (dollars in billions)	$2.11	$8.00	$2.11	$5.01

We view the purchase of mortgage loans benefiting low- and moderate-income families and neighborhoods as an integral part of our mission and business, and remain committed to fulfilling the needs of underserved borrowers and markets. We expect that we will continue to purchase the majority of the single-family and multifamily mortgages counted toward our performance under the housing goals through our standard purchase programs, in conformity with our customary mortgage underwriting standards. We will continue to expand anti-predatory lending and consumer credit education programs and to pilot products that reach creditworthy borrowers otherwise overlooked by traditional lending sources.

From time to time, we also enter into transactions on a large scale or with non-standard terms in order to advance our progress toward meeting the affordable housing goals set by HUD. We entered into two transactions of this type during 2003. One of these transactions involved the acquisition of approximately $6 billion of multifamily mortgages from Washington Mutual Bank, FA and Washington Mutual Bank, which we

refer to collectively as WaMu, during September and October 2003. Among other provisions, the transaction contained a number of contractual incentives, including the payment of fees to WaMu totaling $100 million. WaMu was also granted the option to reacquire all of the mortgages underlying any PC pool created in the transaction by delivering to us all of the PCs related to that pool. The option cannot be exercised until one year after the settlement date for any PC pool. Similarly, in December 2003, we agreed to acquire from Citibank, NA and its affiliates a portfolio of multifamily mortgages that totaled approximately $5 billion. The transaction, involving deliveries of mortgages in 2003 and 2004, included a number of contractual incentives, including payment of fees to Citibank of approximately $24 million in 2003 and an additional $41 million in 2004 and an option to reacquire the mortgages similar to the one granted in the WaMu transaction not exercisable until 18 months after the settlement date for any PC pool. We paid these fees to encourage WaMu and Citibank to enter into these transactions, in part because HUD regulations offered incentives to encourage the acquisition of the type of mortgages involved. However, as noted below, HUD has notified us that it would not renew for 2004 the incentives under the housing goals for the acquisition of the particular type of mortgages involved in the WaMu and Citibank transactions.

If the Secretary of HUD were to find that we failed, or that there was a substantial probability that we would fail, to meet any housing goal and that achievement of the housing goal was or is feasible, the Secretary would require us to submit a housing plan. The housing plan would describe the actions we would take to achieve the goal in the future. HUD also has the authority to issue a cease and desist order and to assess civil money penalties against us in the event that we fail to submit a required housing plan or fail to make a good faith effort to comply with a plan approved by HUD.

In December 2003, HUD notified us that although it was extending the 2000 regulations through 2004, it would not renew for 2004 certain incentives under the housing goals that contributed significantly to our achievement of the goals since 2001. HUD's action will require an increased level of effort on our part to meet each of the goals for 2004.

On May 3, 2004, HUD published for public notice and comment a proposed rule that would establish higher affordable housing mortgage purchase goals for us and Fannie Mae for calendar years 2005 through 2008. The proposed rule would also establish new subgoals for purchase-money mortgages. On July 16, 2004, we filed comments with HUD on the proposed housing goals.

We believe that the adoption of the rule as proposed, or certain market conditions, could adversely affect our results of operations in future years. See also "BUSINESS — Mortgage Purchase and Guarantee Activity — Credit Guarantee" for more information regarding these factors. If a final rule were to be adopted substantially as proposed, we would take measures to reduce or eliminate material adverse business impacts; however, there could be no assurance that any such measures would be fully successful. At the conclusion of the rulemaking process, HUD may promulgate a final rule that differs from, or is the same as, the proposed rule based upon the comments that it receives, or HUD may withdraw the proposed rule entirely. Consequently, we are unable to predict with certainty the future impact of any final rule on our business operations, financial condition or results of operations.

Fair Lending. Our mortgage purchase activities are subject to federal anti-discrimination laws. In addition, the GSE Act requires the Secretary of HUD to adopt regulations prohibiting discriminatory practices in the mortgage purchase activities of both GSEs and periodically to review and comment on our underwriting and appraisal guidelines for consistency with the Fair Housing Act and the GSE Act. The GSE Act also requires the Secretary of HUD to direct that we:

- Submit data to HUD to assist it in investigating whether a mortgage lender with which we do business has failed to comply with the Fair Housing Act or the Equal Credit Opportunity Act, or ECOA; and
- Undertake remedial actions, including suspension, probation, reprimand or settlement, against lenders that are found to have engaged in discriminatory lending practices in violation of the Fair Housing Act or ECOA pursuant to a final adjudication and after opportunity for an administrative hearing.

New Program Approval. Under the GSE Act, we must obtain the approval of the Secretary of HUD for any new program for the purchasing, servicing, selling, lending on the security of, or otherwise dealing in, conventional mortgages that:

- Is significantly different from programs that were previously approved or programs that we engaged in before the date the GSE Act was enacted; or
- Represents a material expansion of programs above limits expressly contained in any prior approval.

HUD has issued regulations implementing the new program approval authority granted under the GSE Act. To date, HUD has not disapproved any of our mortgage programs under these regulations. The Secretary of HUD is required to approve any new program unless the Secretary determines that the new program is not authorized under the Freddie Mac Act or that the program is not in the public interest.

OFHEO. The GSE Act created OFHEO as a separate office within HUD, substantially independent of the Secretary of HUD. OFHEO is headed by the Director, who is appointed by the President of the United States and confirmed by the Senate for a five-year term. The Director of OFHEO has exclusive regulatory authority for ensuring our adequate capitalization and safe and sound operation in accordance with the GSE Act. Among other matters, the GSE Act subjects both us and Fannie Mae to certain minimum, critical and risk-based capital standards issued by OFHEO. See "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements for a discussion of OFHEO's investigation of Freddie Mac in connection with the restatement.

On April 12, 2004, OFHEO proposed for public comment certain revisions to its corporate governance regulation. On June 14, 2004, we submitted comments to OFHEO on these proposed revisions.

The GSE Act establishes our capital standards, and OFHEO has issued regulations that set our minimum, critical and risk-based capital requirements. OFHEO is required to classify our capital adequacy at least quarterly. OFHEO has never classified us as other than "adequately capitalized," the highest possible classification. See "MD&A — LIQUIDITY AND CAPITAL RESOURCES — Capital Resources" for additional information regarding OFHEO's capital rules.

We may pay a dividend on our common or preferred stock without prior OFHEO approval only if our payment would not decrease our Core capital to an amount less than our minimum capital level and would not decrease our Total capital to an amount less than our risk-based capital level. Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), par value of outstanding 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. If our Core capital were to fall below the minimum capital level, we would be able to make a capital distribution only if the Director of OFHEO determined that the distribution satisfied certain statutory standards. If our Total capital were to fall below the risk-based capital level, but our Core capital equaled or exceeded the minimum capital level, we would be prohibited from making a capital distribution (which includes dividend payments, common stock repurchases and preferred stock redemptions) that would decrease our Core capital to an amount less than the minimum capital level. Under these circumstances, we would be prohibited from making any capital distribution that would decrease our Core capital to less than the critical capital level.

In addition to the preceding requirements, the Director of OFHEO has authority, under certain conditions, to require us to submit for the Director's approval a capital restoration plan or to restrict our activities, either of which also could affect adversely our ability to make capital distributions. In connection with the legislative proposals being considered by Congress, the Director's authority to set capital levels may be expanded. See "Legislative Matters — GSE Regulatory Oversight Bill" for more information.

On January 29, 2004, OFHEO announced the creation of a framework for monitoring our capital due to the temporarily higher operational risk arising from our current inability to produce timely financial statements in accordance with GAAP. The framework includes a target capital surplus of 30 percent of our minimum capital requirement, subject to certain conditions and variations; weekly monitoring; and prior approval of certain capital transactions, to verify that appropriate levels of capital are maintained. While OFHEO's framework includes stringent monitoring and imposes restrictions on share repurchases and other capital activities, we do not expect it to adversely affect our disciplined growth strategy in most scenarios. For additional information about the OFHEO target capital surplus framework, see "NOTE 10: REGULATORY CAPITAL" to the consolidated financial statements.

Treasury. Under the Freddie Mac Act, the Secretary of the Treasury has approval authority over all of our issuances of notes, debentures and substantially identical types of unsecured debt obligations (including the interest rates and maturities on these securities), as well as new types of mortgage-related securities issued subsequent to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989. The Secretary of the Treasury has historically performed this debt securities approval function by coordinating GSE debt offerings with Treasury funding activities. Recently, Treasury officials have indicated that they are reviewing the scope of Treasury's authority over our securities issuances.

Voluntary SEC Reporting. On July 12, 2002, we announced an agreement, as a result of a consensus among the Treasury, the Office of Management and Budget, the SEC, OFHEO and us, to initiate a voluntary registration process with the SEC. Once this process is complete, we will be subject to the financial reporting requirements applicable to publicly traded companies under the Exchange Act, including filing with the SEC annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. We will complete our voluntary registration with the SEC as soon as practicable after we return to timely financial reporting and will become subject to these SEC reporting requirements when our Exchange Act registration statement is declared effective by the SEC.

In addition, OFHEO has issued a supplemental disclosure regulation that will obligate us to submit proxy statements and insider transaction reports to the SEC in accordance with rules governing publicly traded companies under the Exchange Act.

These actions do not affect the SEC exemption that Congress provided for our equity, debt and mortgage-related securities in our charter. As part of our July 12, 2002 announcement, the SEC provided written confirmation that our securities will continue to be exempt from the securities offering registration requirements of the Securities Act and certain other provisions of the federal securities laws.

Predatory Lending. We have instituted a comprehensive set of anti-predatory lending policies intended to prevent the purchase or assignment of mortgage loans with unacceptable terms or conditions or resulting from unacceptable practices. In accordance with these policies, we will not purchase:

- Mortgages originated with single-premium credit insurance;
- Mortgages with terms that exceed either the annual percentage rate or the points and fees threshold under the Home Ownership and Equity Protection Act of 1994, or HOEPA;
- Subprime mortgages with prepayment penalty terms that exceed three years; or
- Mortgages with mandatory arbitration clauses originated on or after August 1, 2004.

In addition, we require our servicers to report all borrower credit information, including monthly mortgage payments.

Several states have enacted laws aimed at predatory lending practices, generally with regard to loans exceeding thresholds based on annual percentage rates or financing costs. These loans are typically referred to as "high-cost home loans." The high-cost home loan thresholds trigger state law liabilities for subsequent purchasers or assignees of such loans that may be broader than liabilities imposed upon such purchasers or assignees under HOEPA. Currently, we do not purchase high-cost home loans in the states of Arkansas, Georgia, Illinois, Kentucky, Maine, Nevada, New Jersey, New Mexico, New York and Oklahoma. We

continue to assess newly enacted and proposed state laws to determine our policies with respect to the purchase of loans affected by those laws.

PROPERTIES

We own a 75 percent interest in a limited partnership that owns our principal offices, consisting of four office buildings in McLean, Virginia that comprise approximately 1.2 million square feet. We occupy the headquarters complex under a long-term lease from the partnership. We also lease space for our offices in McLean, Virginia; Reston, Virginia; Washington, D.C.; Atlanta, Georgia; Chicago, Illinois; Dallas, Texas; New York, New York; and Woodland Hills, California.

LEGAL PROCEEDINGS

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.

Furthermore, we are frequently involved, directly or indirectly, in litigation involving mortgage foreclosures. We also are 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 generally involve claims alleging wrongful actions of seller/servicers. Our contracts with our seller/servicers generally provide for them to indemnify us against liability arising from their wrongful actions.

We are also subject to various legal proceedings, including regulatory investigations and administrative and civil litigation, arising from the restatement. These proceedings include class action and stockholder derivative lawsuits, administrative enforcement proceedings commenced by OFHEO, and investigations by the SEC, Department of Labor and the U.S. Attorney's office. We have also received inquiries from the Internal Revenue Service, or IRS, and from the Committee on Energy and Commerce of the U.S. House of Representatives.

Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. For additional information on these proceedings, see "NOTE 13: LEGAL CONTINGENCIES" and "NOTE 14: INCOME TAXES" to the consolidated financial statements.

SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The following matters were presented for stockholder vote at the March 31, 2004 Annual Meeting of Stockholders: (a) election of 13 members to our Board of Directors, each for a term ending on the date of the next annual meeting of our stockholders; and (b) ratification of the appointment of PricewaterhouseCoopers LLP, or PwC, as independent auditors for our 2003 consolidated financial statements. At the meeting, 608,812,644 shares were present in person or by proxy.

Table 5 — Votes of Security Holders

At the meeting, the following persons were elected to our Board of Directors by the respective votes indicated:

	Votes For	Votes Withheld
Joan E. Donoghue	579,380,702	29,431,942
Michelle Engler	561,069,106	47,743,538
Richard Karl Goeltz	581,996,065	26,816,579
George D. Gould	569,699,329	39,113,315
Henry Kaufman	569,717,530	39,095,114
William I. Ledman	568,247,086	40,565,558
John B. McCoy	568,278,696	40,533,948
Shaun F. O'Malley	571,604,456	37,208,188
Ronald F. Poe	567,206,260	41,606,384
Stephen A. Ross	572,639,329	36,173,315
Christina Seix	569,819,767	38,992,877
Richard F. Syron	577,412,690	31,399,954
William J. Turner	567,089,459	41,723,185

The appointment of PricewaterhouseCoopers LLP was ratified at the meeting by the following votes:

Votes for	Votes Against	Abstentions
596,988,834	8,697,063	3,126,747

No matters were submitted to stockholders from April 1, 2004 through the date of the Information Statement.

MARKET PRICE FOR THE COMPANY'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information

Our common stock, par value $0.21 per share, is listed on the NYSE and the Pacific Stock Exchange under the symbol FRE. From time to time, our common stock may be admitted to unlisted trading status on other national securities exchanges. Put and call options on our common stock are traded on U.S. options exchanges. As of December 31, 2003, there were 688,573,911 shares outstanding of our common stock.

Table 6 sets forth the high and low sale prices of our common stock for the periods indicated.

Table 6 — Quarterly Common Stock Information

	Sale Prices(1)(2)	
	High	Low
2004 Quarter Ended		
June 30	$64.62	$56.45
March 31	65.15	57.60
2003 Quarter Ended		
December 31	$59.75	$52.65
September 30	56.04	47.35
June 30	61.40	46.48
March 31	64.78	49.53
2002 Quarter Ended		
December 31	$64.45	$53.85
September 30	65.59	52.60
June 30	68.50	59.80
March 31	69.50	60.71

(1) The principal market is the NYSE, and prices are based on the Composite Tape. Our common stock is also listed on the Pacific Stock Exchange.
(2) High and low sales prices reflect intraday trading activity during the period.

As of August 31, 2004, the closing price for our common stock was $67.12 per share. As part of a stock repurchase plan approved by our Board of Directors, we are authorized to repurchase our common stock in an amount up to 5 percent of our shares outstanding as of September 5, 1997, which was approximately 34 million shares. At December 31, 2003, approximately 13 million common shares remained available for repurchase under this plan. We did not repurchase any common stock during 2003 or the first eight months of 2004, and we do not expect to engage in share repurchases until after we resume timely financial reporting. See "Business — Regulatory and Government Relationships — *Regulatory Matters* — OFHEO" for more information.

Dividends

Table 7 sets forth the dividend per common share that we have paid for the periods indicated.

Table 7 — Dividends Per Common Share

	Regular Cash Dividend Per Share
2004 Quarter Ended	
June 30	$0.30
March 31	0.30
2003 Quarter Ended	
December 31	$0.26
September 30	0.26
June 30	0.26
March 31	0.26
2002 Quarter Ended	
December 31	$0.22
September 30	0.22
June 30	0.22
March 31	0.22

Each stockholder is entitled to receive dividends that may be declared by our Board of Directors out of legally available funds. We have historically paid dividends to our stockholders in each quarter. Our Board of Directors intends to retain this policy of providing dividends quarterly, but further dividends will depend upon earnings, financial condition and other factors relevant at the time our Board of Directors considers our dividend policy and the declaration of specific dividends. See "NOTE 10: REGULATORY CAPITAL" to the consolidated financial statements for additional information regarding dividend payments and "NOTE: 9: STOCKHOLDERS' EQUITY" to the consolidated financial statements for additional information regarding our preferred stock dividend payments.

Holders

As of August 25, 2004, we had approximately 2,700 common stockholders of record. Based on the number of requests for proxies, we estimate that approximately 248,000 additional common stockholders held shares through banks, brokers and nominees as of August 25, 2004.

Securities Authorized for Issuance under Equity Compensation Plans

Table 8 provides information about our common stock that may be issued upon the exercise of options, warrants and rights under our existing equity compensation plans as of December 31, 2003. Our stockholders have approved the 1995 Directors' Stock Compensation Plan, the 1995 Stock Compensation Plan, as amended and restated, the 1995 Employee Stock Purchase Plan and the terms of the 1990 Stock Compensation Plan.

Table 8 — Securities Authorized for Issuance under Equity Compensation Plans

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by stockholders	10,017,319[1]	$40.83[2]	9,503,542[3]
Equity compensation plans not approved by stockholders	None	N/A	None

(1) Includes 1,295,722 restricted stock units issued under the 1995 Directors' Stock Compensation Plan and the 1995 Stock Compensation Plan and options to purchase 65,257 shares under the Employee Stock Purchase Plan.
(2) For the purpose of calculating this amount, the restricted stock units are assigned a value of zero.
(3) Includes 4,361,954 shares, 3,481,774 shares and 1,659,814 shares available for issuance under the 1995 Stock Compensation Plan, the Employee Stock Purchase Plan and the 1995 Director's Stock Compensation Plan, as amended and restated in 1998, respectively. No shares are available for issuance under the 1990 Stock Compensation Plan.

FORWARD-LOOKING STATEMENTS

We regularly communicate information concerning our business activities to investors, securities analysts, the news media and others as part of our normal operations. Some of these communications include "forward-looking statements" pertaining to our current expectations about our objectives for financial reporting, future business plans, results of operations, financial condition and trends. Forward-looking statements are typically accompanied by, and identified with, terms such as "estimates," "anticipates," "believes," "expects," "intends," "objectives," "will," "may," "might," "could," "would," and similar phrases. This Information Statement includes forward-looking statements. These statements are based on current plans, estimates and projections. Forward-looking statements involve known and unknown risks, uncertainties and other factors, some of which are beyond our control. You should be careful about relying on any forward-looking statements. You should also consider all risks, uncertainties and other factors described in this Information Statement in considering any forward-looking statements. Factors that could cause actual results to differ materially from the expectations expressed in these and other forward-looking statements by management include, among others:

- Changes in the level and volatility of interest rates, house prices, employment rates and the general economy;
- Changes in our strategies for and results of credit loss mitigation, interest-rate and other market risk management activities and investment activities;
- The availability of debt funding and equity capital in sufficient quantity and at attractive rates to support continued growth in our Retained portfolio, to refinance maturing debt and to meet regulatory capital requirements;
- Actions by governmental entities, securities rating agencies or others that could adversely affect the supply or cost of equity capital or debt financing available to us;
- The availability from acceptable counterparties of options, interest-rate and currency swaps, and other derivative financial instruments, or derivatives, of the types and in the quantities needed for investment funding and risk management purposes;
- The rate of growth in total outstanding U.S. residential mortgage debt;
- The size of the residential mortgage market;
- Concentration of the sources of mortgage loans in a small number of originators;
- Borrower preferences for fixed-rate mortgages or ARMs;
- Preferences of originators to sell mortgages into the secondary market;
- Changes in investor preferences for mortgage loans and mortgage-related and debt securities versus other investments;
- Changes in foreign exchange rates;
- Competition in the mortgage market and in the market for mortgage-related and debt securities;
- Our ability to effectively manage interest-rate and other market risks and credit risk;
- Our ability to identify, manage, mitigate and/or remedy internal control weaknesses and other operational risks;
- Our ability to implement business processing improvements;
- Volatility of reported results due to changes in fair value of certain instruments/assets;
- Our ability to effectively and timely implement the remediation plan undertaken as a result of the restatement of our consolidated financial statements and the consent order entered into with our safety and soundness regulator, OFHEO, including particular initiatives relating to technical infrastructure and controls over financial reporting;
- Developments in, outcomes of, impacts of, and costs, expenses, settlements and judgments related to government investigations and civil litigation in which we are involved;
- Significant business disruptions resulting from acts of war or terrorism;

- The occurrence of a major natural or other disaster in a geographic area in which our total mortgage portfolio is heavily concentrated;
- The degree to which our business and financial forecasting methods accurately predict actual results;
- The impact of new accounting standards, including the timely development of supporting systems; and
- Changes in the legislative or regulatory environment, our Congressional charter, affordable housing goals, regulatory capital requirements, including the temporary 30 percent target minimum capital surplus imposed on us by OFHEO in January 2004, and the exercise or assertion of regulatory or administrative authority beyond current practice.

We undertake no obligation to update these forward-looking statements to reflect events or circumstances after the date of this Information Statement, or to reflect the occurrence of unanticipated events.

SELECTED FINANCIAL DATA[1][2]

	At or for the Year Ended December 31,			
	2003	2002	2001	2000
	(dollars in millions, except share-related amounts)			
Income Statement Data				
Net interest income[3]	$ 9,498	$ 9,525	$ 7,448	$ 3,758
Non-interest income (loss)[3]	(259)	7,143	(1,602)	2,647
Income before cumulative effect of change in accounting principles, net of taxes	4,816	10,090	3,115	3,666
Cumulative effect of change in accounting principles, net of taxes	—	—	43	—
Net income	$ 4,816	$ 10,090	$ 3,158	$ 3,666
Earnings per common share before cumulative effect of change in accounting principles, net of taxes				
Basic[4]	$ 6.69	$ 14.22	$ 4.19	$ 5.04
Diluted[4]	6.68	14.17	4.17	5.01
Earnings per common share after cumulative effect of change in accounting principles, net of taxes				
Basic[4]	$ 6.69	$ 14.22	$ 4.25	$ 5.04
Diluted[4]	6.68	14.17	4.23	5.01
Dividends per common share	1.04	0.88	0.80	0.68
Weighted average common shares outstanding (in thousands)				
Basic	687,094	692,727	692,603	692,097
Diluted	688,675	695,116	695,973	695,307
Balance Sheet Data				
Total assets	$ 803,449	$ 752,249	$ 641,100	$462,803
Debt securities, net due within one year	295,262	244,429	264,227	183,374
Debt securities, net due after one year	438,738	415,662	311,013	244,732
Subordinated debt, due after one year	5,613	5,605	3,128	144
Miscellaneous liabilities[5]	30,420	52,914	40,489	14,252
Minority interest in consolidated subsidiaries	1,929	2,309	2,619	2,944
Stockholders' equity	31,487	31,330	19,624	17,357
Portfolio Balances[6]				
Retained portfolio (unpaid principal balances)[7]	$ 645,466	$ 567,272	$ 497,639	$392,298
Total PCs issued and Structured Securities (unpaid principal balances)[8]	1,162,068	1,090,624	961,511	838,323
Total mortgage portfolio (unpaid principal balances)	1,414,399	1,316,609	1,150,723	975,612
Ratios				
Return on average assets[9]	0.6%	1.4%	0.6%	0.9%
Return on common equity[10]	17.2	47.2	20.2	39.0
Return on total equity[11]	15.3	39.6	17.1	30.2
Dividend payout ratio on common stock[12]	15.6	6.2	18.9	13.6
Equity to assets ratio[13]	4.0	3.7	3.4	2.9

(1) Effective January 1, 2003, we adopted the provisions of FASB Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," or FIN 45, and FASB Staff Position 45-2, "Whether FASB Interpretation No. 45, 'Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,' or FSP FIN 45-2, Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value," or FSP 45-2. We also adopted the provisions of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," or SFAS 133, and the provisions of Emerging Issues Task Force, or EITF 99-20 "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," as of January 1, 2001 and April 1, 2001, respectively. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to our consolidated financial statements for more information.

(2) Information at or for the year-ended December 31, 1999 is omitted because we did not restate our consolidated financial statements for periods prior to 2000.

(3) In accordance with interpretive guidance on SFAS 133, published by the Office of the Chief Accountant of the SEC, we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in a qualifying hedge accounting relationship from Income (expense) related to derivatives, a component of Net interest income, to Derivative gains (losses), a component of Non-interest income, for 2002 and 2001. These reclassifications, which decreased Derivative gains (losses) and increased Income (expense) related to derivatives, totaled $639 million and $456 million for 2002 and 2001, respectively. In 2000, SFAS 133 was not in effect and the amount recorded in Net interest income for derivatives not designated in a qualifying hedge accounting relationship was not significant.

(4) In accordance with the requirements of EITF Topic No. D-42, "The Effect of the Calculation of Earnings Per Share for the Redemption or Induced Conversion of Preferred Stock," or EITF D-42, we restated the 2002 amount of Preferred stock dividends and issuance costs on redeemed preferred stock reported on our consolidated statements of income. For the year ended December 31, 2002, the restatement increased by $5 million the amount representing issuance costs on redeemed preferred stock and therefore reduced Net income available to common stockholders by $5 million. This caused a reduction in both basic and diluted earnings per share for the same year by $0.01 per share. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for additional information.

(5) Includes Due to Participation Certificate investors, Accrued interest payable, Guarantee obligation for Participation Certificates, Derivative liabilities, at fair value, Reserve for guarantee losses on Participation Certificates and Other liabilities.

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

(7) The Retained portfolio presented in our consolidated balance sheets differs from the Retained portfolio on this table because the consolidated balance sheets caption includes valuation adjustments (*e.g.*, fair value adjustments for securities classified as available for sale and trading and the Reserve for losses on mortgage loans held for investment) and deferred balances (*e.g.*, premiums and discounts). See "Table 2 — Reconciliation of Retained Portfolio Unpaid Principal Balances to the Consolidated Balance Sheets."

(8) Represents PCs, Structured Securities and other credit guarantees of mortgage loans held by third parties. The balances and activities are based on the collateral underlying the PCs and Structured Securities.

(9) Ratio computed as Net income divided by the simple average of beginning and ending Total assets.

(10) Ratio computed as Net income available to common stockholders divided by the simple average of beginning and ending Stockholders' equity, net of Preferred stock (at redemption value).

(11) Ratio computed as Net income divided by the simple average of beginning and ending Stockholders' equity.

(12) Ratio computed as Common stock dividends declared divided by Net income available to common stockholders.

(13) Ratio computed as the simple average of beginning and ending Stockholders' equity divided by the simple average of beginning and ending Total assets.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The discussion that follows, particularly the discussion under the caption "Business Outlook," includes forward-looking statements describing results and trends for business performance metrics during the first part of 2004, as well as our outlook for certain metrics for the full year ending December 31, 2004. Actual results will depend on a number of factors such as changes in interest rates and other market conditions and may differ from the outlook discussed below. See "FORWARD-LOOKING STATEMENTS" for additional information.

EXECUTIVE SUMMARY

Overview

We generate revenue from two primary sources: management and guarantee income from our credit guarantee activities and net interest income from our portfolio investment activities.

Management and guarantee income represents the fee we charge mortgage originators or servicers to guarantee the payment of principal and interest. This fee is compensation for:

- Guaranteeing the payment of principal and interest to security holders; and
- Costs incurred in administering payments on these securities, including expenses related to the timing difference between the receipt of principal and interest payments from seller/servicers and the remittance of those payments to security holders. (See "Due to Participation Certificate Investors" in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for further information regarding the timing difference related to the PC remittance cycle).

The accounting policies we apply to our credit guarantee activities significantly affect the volatility of our reported earnings in a number of ways, including through the initial recognition of the fair value of guarantee assets and guarantee obligations in connection with sales of PCs and Structured Securities, the recognition of subsequent gains or losses from the change in fair value of guarantee assets and PC residuals generated from such sales, and the repurchase of PCs into our Retained portfolio.

Net interest income is the difference between interest income earned on mortgages and mortgage-related assets and interest expense owed on debt. To manage the interest-rate and other market risks associated with portfolio investments and to reduce financing costs, we enter into interest-rate swaps, options and other derivatives. Although we execute derivative transactions to manage interest-rate risk, they may significantly affect, and increase the volatility of, our reported earnings. This is particularly the case where the derivative is not accounted for in a hedge accounting relationship, because the fair value gains and losses on such transactions are recorded on our income statement without the offsetting change in the value of the economically hedged risk being recognized in earnings.

In addition to management and guarantee income and net interest income, Freddie Mac generates revenue from fee-based activities. For instance, we earn fees associated with servicing and technology-related programs, including Loan Prospector® (our automated underwriting system).

2003 Summary Of Results

Our 2003 operating performance underscores the strength of our underlying business and our commitment to our mission. During 2003, we financed homes for approximately 6 million families, including 2.5 million low- and moderate-income families, 184,000 first-time homebuyers and 720,000 minority families.

Our net income was $4.8 billion for 2003, a decrease of 52 percent from $10.1 billion for 2002. The net decrease for 2003 was primarily driven by a substantial decrease in total non-interest income. Non-interest income results continue to be affected by changes in unrealized gains and losses on certain financial instruments that we report at fair value. Changes in the level and volatility of interest rates have resulted in significant period-to-period volatility in our reported net income. To the extent changes in interest rates

continue to be significant, our overall net income will remain volatile. However, it is important to note that while our reported net income under GAAP was volatile, our interest-rate risk remained low, as demonstrated by the low levels of portfolio market value sensitivity, or PMVS, and duration gap throughout 2003. See "CRITICAL ACCOUNTING POLICIES" for more information.

Net interest income was down slightly, totaling $9.498 billion in 2003, compared to $9.525 billion in 2002. The decline in 2003 results was attributable to lower yields on assets acquired in 2003 and increased amortization expense related to premiums paid on interest earning assets, largely offset by the positive effects of a decrease in average debt funding costs and growth in the Retained portfolio.

Net interest yield decreased to 127 basis points in 2003 from 146 basis points in 2002. The decline in interest yield was driven by increased amortization expense related to premiums paid on interest-earning assets and by the addition of lower-yielding mortgage-related securities in 2003, which exceeded the benefit of improved funding costs and lower derivative-related expenses during 2003. During the first quarter of 2003, we refined the assumptions and calculations for the amortization of deferred fees recorded as discounts on assets in our Retained portfolio, most notably with regard to estimates of future prepayments. The effect on net interest income of refining these assumptions, which was treated as a change in estimate and also impacted management and guarantee income as noted below, was the recognition of $31 million of additional amortization income during the first quarter of 2003.

Management and guarantee income, which is a component of Non-interest income (loss) on the consolidated statements of income, was $1.6 billion in 2003, compared to $1.5 billion in 2002. Reported management and guarantee income consists of the guarantee fee on outstanding PCs, and the amortization of certain fees paid by the seller/servicer at the time of securitization that are amortized into management and guarantee income over the estimated life of the security. The increase in reported management and guarantee income in 2003 was driven by a 3 percent increase in the average balance of outstanding PCs and an increase in net amortization income related to the fees paid to us. As noted above, during the first quarter of 2003, we refined the assumptions and calculations for this fee amortization, most notably with regard to estimates of future prepayments. The effect on management and guarantee income of refining these assumptions, which was treated as a change in estimate, was the recognition of $110 million of additional amortization income during the first quarter of 2003. These positive impacts were partially offset by a decrease in the average contractual guarantee fee on outstanding PCs.

Non-interest income (loss), excluding Management and guarantee income, totaled ($1.9) billion in 2003, compared to $5.6 billion in 2002. The large decrease in comparison to 2002 was primarily due to: (a) a significantly smaller net mark-to-fair value gain on derivative instruments in 2003 of $39 million, compared to $5.3 billion in 2002; (b) losses on investment activity of ($1.1) billion in 2003, compared to gains of $1.8 billion in 2002 (primarily due to a net mark-to-fair value loss on trading securities in 2003 of ($2.1) billion compared to a net gain of $0.9 billion in 2002); and (c) an increase in losses on debt retirements to ($1.8) billion in 2003, from ($0.7) billion in 2002.

Non-interest expense totaled $2.2 billion in 2003, compared to $1.9 billion in 2002. During 2003, we incurred significant increases in Other expenses primarily due to accounting, auditing and consulting costs of approximately $124 million and legal costs of approximately $48 million associated with the restatement and related remediation activities, the $125 million civil money penalty imposed by OFHEO, fees of $124 million that were paid in connection with certain multifamily affordable housing transactions, and additional expense of $75 million for a loss contingency related to the proceedings arising from the restatement. See "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements for additional information about legal and regulatory proceedings. Our 2002 results include a $225 million charge related to a special cash contribution to our philanthropic program, which includes the Freddie Mac Foundation and corporate giving programs. We did not make a similar contribution in 2003.

Total stockholders' equity increased to $31.5 billion at December 31, 2003 from $31.3 billion at December 31, 2002. The primary drivers of the net increase were an increase in retained earnings partially offset by a decrease in Accumulated other comprehensive income (loss), or AOCI, net of taxes. Retained earnings increased as a result of net income in 2003, which was driven by the factors discussed previously, partially offset by $0.9 billion in dividends declared in 2003. The decrease in AOCI, net of taxes of ($3.8)

billion was due to high prepayment activity related to higher coupon securities and higher interest rates at the end of 2003 compared to the end of 2002, which resulted in a net decrease in the mark-to-fair value of available-for-sale securities of ($5.9) billion, partially offset by a decrease in deferred losses related to the effective portion of derivatives accounted for as cash flow hedges of approximately $2.0 billion. The fair value of our available-for-sale securities tends to decrease as interest rates rise. Derivatives accounted for in cash flow hedge relationships primarily consist of pay-fixed interest-rate swaps, which tend to generate gains when interest rates rise.

As discussed in "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements, we are subject to various legal proceedings, including regulatory investigations and administrative and civil litigation, arising from the restatement. We believe that a loss in connection with the proceedings arising from the restatement is probable and currently estimate the range of minimum loss to be from $75 million to $100 million. We have established a reserve of $75 million for this loss contingency in the second quarter of 2003, the period in which many of the legal proceedings were initiated. The ultimate resolution of these proceedings could result in losses lower than or in excess of the estimated range of minimum loss. Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. It is not possible for us to reasonably estimate the upper end of the range of any additional losses that might result from adverse resolutions of any of these legal proceedings, or their potential effect on our financial condition or results of operations.

In December 2003, we entered into a consent order with OFHEO. Under the terms of the consent order, we paid a $125 million civil money penalty and we are undertaking a variety of remedial actions in accordance with a prescribed schedule. See "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements for more information.

Fair Value Balance Sheets For December 31, 2003 and 2002

We believe fair value measures provide an important view of our business economics and risks because fair value takes a consistent approach to the representation of all financial assets and liabilities, rather than an approach that combines historical cost and fair value techniques, as is the case with our GAAP consolidated financial statements.

As presented in "CONSOLIDATED FAIR VALUE BALANCE SHEETS," at December 31, 2003, the fair value of net assets (net of tax effect) was $27.3 billion, a $4.4 billion, or 19 percent, increase from December 31, 2002. For the same period, the fair value of net assets attributable to common stockholders (representing the fair value balance sheet total net assets less the fair value of net assets attributable to preferred stockholders) was $22.9 billion, a $4.6 billion, or 25 percent, increase from December 31, 2002. The difference between the $4.4 billion increase and the $4.6 billion increase relates to the change in the fair value of preferred stock. Among the primary contributors to the increase in 2003 fair value balance sheet net assets were core spread income (defined as the income we expect to earn from the spread between mortgage investments and debt, calculated on an option-adjusted basis), guarantee fees on PCs and Structured Securities held by third parties and other fee income. As discussed below under "Business Outlook," the fair value growth percentage achieved in 2003 exceeded our long-run expectations.

2003 Business Volumes

Total Mortgage Portfolio

The total mortgage portfolio grew 7 percent to $1.414 trillion at December 31, 2003, from $1.317 trillion at December 31, 2002. New business purchase volume (which excludes purchases of PCs for the Retained portfolio) was $834.9 billion in 2003, up from $650.7 billion in 2002. Total mortgage portfolio liquidations were $737.1 billion in 2003, up from $484.8 billion in 2002.

Retained Portfolio

The Retained portfolio unpaid principal balance grew 14 percent to $645.5 billion at December 31, 2003, from $567.3 billion at December 31, 2002. Mortgage-related investment opportunities were most attractive

during the second and third quarters, but began to lessen in the fourth quarter as strong demand from other investors, coupled with lower mortgage originations, resulted in tighter mortgage-to-debt spreads.

The Retained portfolio and its related debt funding are the primary source of our interest-rate risk. In 2003, our interest-rate risk remained low. We provide investors with monthly interest-rate risk sensitivity disclosures in our Monthly Volume Summary report, which is available on our website at www.FreddieMac.com, using our primary interest-rate risk measures: PMVS and duration gap. PMVS-Level, or PMVS-L, one of the two ways we measure PMVS, estimates the sensitivity of our fair value of net assets attributable to common stockholders to immediate adverse shifts in the level of interest rates. (We are providing this reference to the Monthly Volume Summary report solely for the information of interested persons. We are not using references to this report here or elsewhere in this Information Statement to incorporate additional information into this Information Statement.) Duration gap estimates the average daily difference (measured in months) between the estimated weighted-average lives of our financial assets, liabilities and derivatives.

Total PCs and Structured Securities Issued and Outstanding PCs and Structured Securities

Total PCs and Structured Securities issued, which represents the unpaid principal balance of all PCs and Structured Securities issued by us, grew 7 percent, lagging the 12.5 percent growth in U.S. residential mortgage debt outstanding. Total PCs and Structured Securities issued increased to $1.162 trillion at December 31, 2003, from $1.091 trillion at December 31, 2002. Historically, growth in Total PCs and Structured Securities issued has slightly exceeded the growth in U.S. residential mortgage debt outstanding. The below market growth in 2003 was primarily caused by weak PC price performance, together with a substantial reduction in deliveries to us from one of our significant mortgage originators and adverse market reaction to additional credit fees we charged for lower credit quality loans. Outstanding PCs and Structured Securities (equal to Total PCs and Structured Securities issued less PCs and Structured Securities held in the Retained portfolio or held as part of our PC market-making and support activities) grew 3 percent to $752.2 billion at December 31, 2003, from $729.8 billion at December 31, 2002.

Guarantee Fees/Security Performance

In the second quarter of 2003, the demand for and price of PCs weakened relative to comparable Fannie Mae securities. Customer contracts typically establish a fixed guarantee fee commitment for each mortgage product (*e.g.*, 15-year fixed-rate, 30-year fixed rate, or ARMs) during the period the contract is in effect. The negotiated guarantee fee contained in these contracts is based on the value created for the seller through sales of mortgage loans to us in comparison to the sales alternatives that exist. The attractiveness of the execution we offer is based on this fixed guarantee fee and the market price of the PCs we create. In June 2003, we began taking action to improve our market share by broadly implementing a pricing feature that adjusts the contract guarantee fee by the security price execution difference (the current level of security price spreads on single class mortgage-related securities issued by us and Fannie Mae) at the time of the loan sale to us. This feature adjusts guarantee fees upward or downward as the security price differential moves. Given the weak performance of our PCs in the second half of 2003, the pricing feature caused the contractual guarantee fees on new business to be adjusted downward.

Credit Losses

Our total credit losses, defined as real estate owned, or REO, operations income (expense) plus net charge-offs, rose slightly in 2003 but were still low as a percentage of the average total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and the portion of Structured Securities backed by Ginnie Mae certificates). These positive results during 2003 were driven by the quality of our total mortgage portfolio and favorable economic conditions, primarily low mortgage rates and continued single-family house-price appreciation. Our single-family credit loss results also continued to reflect the benefits of automated underwriting, loss mitigation activities, high levels of credit enhancement we have obtained on our existing mortgage portfolio and overall strong nationwide house-price appreciation. Multifamily market vacancy rates continued to rise in 2003, but our portfolio had minimal losses. See "RISK MANAGEMENT — Credit Risk" for more information.

Business Outlook

Financial Results for the First Half of 2004

Under GAAP, some of our assets and liabilities are measured at historical cost while others are measured at fair value. This mixed model exposes our reported results to significant volatility. For example, our GAAP net income reflects fair value gains and losses on derivative instruments we hold that are not designated in hedge accounting relationships. While we use these derivatives to economically hedge the interest-rate risk of our mortgage business, the fair value of these derivatives can fluctuate significantly from period to period, based on changes both in interest rate levels and implied volatilities. The recognition of these fair value fluctuations in income can make our GAAP results very volatile from quarter to quarter and year to year, affecting our reported net income, retained earnings and regulatory capital position. We expect this type of volatility to adversely affect our GAAP results in the first half of 2004. While period-to-period changes in the value of these derivatives must be monitored for their impact on reported earnings and regulatory capital adequacy, we do not regard periodic, unrealized gains and losses on derivatives as a meaningful indicator of our long-term success in generating economic returns on deployed capital.

Retained Portfolio

During the first part of 2004, our Retained portfolio purchases were low due to tight mortgage-to-debt option-adjusted spreads. Together with high liquidations, this caused a net decrease in the Retained portfolio. The combination of an increase in the percentage of originations in ARMs, wider option-adjusted spreads, and slower liquidation rates on our existing portfolio have resulted in higher Retained portfolio growth in recent months. Agency and AAA-rated non-agency adjustable-rate mortgage products currently produce attractive risk-adjusted returns and represent an increasing percentage of our total purchases. While we still anticipate the net Retained portfolio growth rate to be below the growth rate of mortgage debt outstanding for the full-year 2004, we now expect that the Retained portfolio growth rate for the year will be in the low to middle single digits. However, market conditions such as demand from other investors, mortgage origination volumes and product mix, and liquidation rates could cause the actual growth rate to vary substantially from our current expectations.

Regulatory Capital

We believe the current level of our capital is adequate to meet all regulatory capital requirements, and the target capital surplus established by OFHEO in January 2004 equal to 30 percent of our minimum capital requirement. For additional information regarding the target capital surplus, see "Capital" below.

Fair Value Balance Sheet Net Asset Growth

A significant portion of our fair value balance sheet net asset growth for 2003 was due to the tightening of mortgage-to-debt option-adjusted spreads as of December 31, 2003. As a result, the increase in fair value balance sheet net assets for 2003 was above our long-term expectations. The 2004 outlook for this metric is inherently uncertain because the final results will depend heavily on market conditions as of December 31, 2004. Mortgage-to-debt option-adjusted spreads are currently wider than at December 31, 2003. If current conditions remain in place, we expect fair value balance sheet net asset growth in 2004, if any, to be significantly below the growth seen in 2003. In addition, if mortgage-to-debt option-adjusted spreads widen materially from the current levels, then the fair value of net assets could decline in 2004.

Total PCs Issued

In 2004, we expect the growth rate of our Total PCs issued to be between 7 percent and 9 percent, slightly lagging the 10 percent anticipated growth rate in U.S. residential mortgage debt outstanding. As mortgage rates change over time, the ratio of fixed-rate mortgages to ARMs will change. As rates rise, the market tends to produce a higher ratio of ARMs. Bank portfolios typically retain a large percentage of ARMs. In 2004, we expect interest rates to rise and the proportion of ARMs originated to increase. As a result, bank portfolios will likely retain a larger percentage of the loans they originate in whole loan form and the percentage of loans sold to the GSEs will decline.

Guarantee Fees/Security Performance

In the second quarter of 2003, the demand for and price of our PCs weakened relative to comparable Fannie Mae securities. As discussed above under "2003 Business Volumes," in June 2003 we began to take action to improve our security performance by broadly implementing a pricing feature that adjusts the contract guarantee fee by the security price execution difference (as previously defined). The downward pricing adjustments that we made to certain mortgages securitized in the second half of 2003 have caused the contractual guarantee fee on new business to be adjusted downward and therefore will affect the contractual guarantee fee collected. During the first eight months of 2004, PC prices have strengthened compared to the second half of 2003. This recovery is expected to have a positive impact on guarantee fees on new business purchases, reflecting the improvement in our security prices relative to the competition.

Credit Losses

Although single-family credit losses are expected to increase from recent levels, we currently expect single-family market conditions to remain favorable and, given our strong credit position, we expect single-family credit losses to remain low as a percentage of the average total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and the portion of Structured Securities backed by Ginnie Mae certificates). Multifamily market vacancy rates are expected to stabilize in late 2004 and early 2005, with many rental markets experiencing slow recovery from recent widespread market weakness. Nevertheless, we expect delinquencies in the multifamily portfolio to increase somewhat this year, as loans in weaker markets default. Although we expect multifamily credit losses to remain low in 2004, we expect to see an increase in 2005.

Administrative Expenses

We expect administrative expenses, which include Salaries and employee benefits, Occupancy expense and certain Other expenses such as professional services and audit fees, to be higher than historical levels at least through 2005 due to the significant infrastructure and control remediation efforts that are necessary to address the material weaknesses in controls surrounding our financial reporting.

Capital

Table 9 summarizes our regulatory capital surpluses at the end of each quarter in 2003 based on data reported to OFHEO. In the case of the minimum and critical capital surplus, amounts shown in the table represent the excess of our Core capital over our minimum and critical capital requirements, as applicable. The estimates of minimum and critical capital surplus amounts reported for the second, third and fourth quarters of 2003 have been revised from the amounts included in our Information Statement Supplement dated June 30, 2004 to reflect: (a) a loss contingency reserve recorded in the second quarter of 2003 related to proceedings arising from the restatement; and (b) the OFHEO civil money penalty that is now recorded in the second quarter of 2003, which had been previously recorded in the fourth quarter of 2003. See "2003 Summary of Results" and "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements for further information. We have submitted to OFHEO amended minimum capital reports for the second, third and fourth quarters of 2003 that reflect this reserve. OFHEO is the authoritative source of the capital calculations that underlie our capital calculation. Risk-based capital surplus represents the excess of our Total capital over our risk-based capital requirement as calculated by OFHEO. OFHEO determined not to recalculate the risk-based capital amounts given that the minimum capital requirement remained the determining requirement for our classification as adequately capitalized.

Table 9 — Regulatory Capital Surpluses as Reported to OFHEO[1]

	2003			
	1Q	2Q	3Q	4Q
	(dollars in millions)			
Minimum Capital Surplus	$ 9,065	$10,185	$ 8,322	$ 9,211
Critical Capital Surplus	$19,857	$21,467	$20,295	$20,888
Risk-Based Capital Surplus	$21,314	$24,620	$27,168	$28,010

(1) See "Table 43 — Regulatory Capital Requirements" for additional information regarding our regulatory capital requirements and capital surpluses.

On January 29, 2004, OFHEO announced the creation of a framework for monitoring our capital due to the temporarily higher operational risk arising from our current inability to produce timely financial statements in accordance with GAAP. The framework includes a target capital surplus of 30 percent of our minimum capital requirement, subject to certain conditions and variations, weekly monitoring, and prior approval of certain capital transactions, to verify that appropriate levels of capital are maintained. While OFHEO's framework includes stringent monitoring and imposes restrictions on share repurchases and other capital activities, we do not expect it to adversely affect our disciplined growth strategy in most scenarios. Had the target capital surplus been in effect at December 31, 2003, our estimated surplus in excess of the target would have been approximately $2.1 billion. For additional information, see "LIQUIDITY AND CAPITAL RESOURCES — Capital Resources — *Capital Adequacy*" and "NOTE 10: REGULATORY CAPITAL" to the consolidated financial statements.

We do not expect to engage in share repurchases until after we resume timely financial reporting. As long as the capital monitoring framework established by OFHEO remains in effect, any such repurchases will require prior approval by OFHEO.

CRITICAL ACCOUNTING POLICIES

The notes to the consolidated financial statements contain a summary of our significant accounting policies, including a discussion of recently issued accounting pronouncements. Certain of these policies as well as estimates we made are critical to the presentation of our financial condition since they are particularly sensitive to our judgment and are highly complex in nature. Some of these policies and estimates relate to matters that are inherently uncertain. Actual results could differ from our estimates and it is possible that such differences could have a material impact on the consolidated financial statements. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for additional information about these and other accounting policies. We have discussed each of these critical accounting policies and the significant related estimates with the Audit Committee of the Board of Directors.

Fair Value

The measurement of fair value is fundamental to the presentation of our financial condition and results of operations in our consolidated financial statements. Fair value is defined as an estimate of the amount at which an instrument could be bought and sold between willing parties, in an active market and not in a forced or liquidation sale. The estimation of fair value involves significant judgment by us. We record many of our financial instruments at fair value in the consolidated balance sheets, with changes in these fair values recognized as gains and losses in the consolidated statements of income or AOCI which is part of stockholders' equity. We also prepare a fair value-basis balance sheet, which presents our assets and liabilities at fair value (including instruments such as debt which are presented at amortized cost in the GAAP financial statements). The fair value balance sheet satisfies our disclosure requirements under SFAS No. 107, "Disclosures About Fair Values of Financial Instruments," or SFAS 107, and is a tool to communicate our financial position and results on a fair value basis. See "CONSOLIDATED FAIR VALUE BALANCE SHEETS" and "NOTE 16: FAIR VALUE DISCLOSURES" to the consolidated financial statements for more information.

Table 10 summarizes our assets and liabilities that are recorded at fair value in the consolidated GAAP balance sheets at December 31, 2003 and 2002.

Table 10 — Assets and Liabilities Recorded at Fair Value

	December 31,	
	2003	2002
	(dollars in millions)	
Retained portfolio		
Mortgage-related securities:		
Available for sale, at fair value	$581,326	$496,265
Trading, at fair value	18,200	29,104
Participation Certificate residuals, at fair value	671	412
Investments		
Mortgage-related securities:		
Trading, at fair value	32,817	32,366
Participation Certificate residuals, at fair value	(5)	8
Non-mortgage-related securities:		
Available for sale, at fair value	31,228	66,419
Trading, at fair value	1,314	2,409
Other assets		
Derivative assets, at fair value	16,180	10,393
Guarantee asset for Participation Certificates, at fair value	3,686	2,445
Selected debt securities, net		
Securities sold, not yet purchased, at fair value	733	6,356
Other liabilities		
Derivative liabilities, at fair value	357	967

Fair value affects our earnings in a variety of ways. For certain financial instruments that are carried at fair value (such as securities classified as trading, derivatives with no hedge designation, liabilities representing short sales of Treasury securities, and guarantee assets and PC residuals), changes in fair value are recognized in current period earnings. These income effects are classified in several captions, including Gains (losses) on investment activity, Derivative gains (losses) and Gains (losses) on guarantee assets for PCs, at fair value. For other instruments that are carried at fair value (such as securities classified as available for sale and derivatives in cash flow hedge relationships), changes in fair value are generally deferred, net of tax, in AOCI. The deferred gains and losses in AOCI, initially measured at fair value, are recognized in earnings over time through the application of various accounting policies concerning amortization, sale recognition for securities sold from the available-for-sale category, and impairment recognition. Furthermore, impairments of mortgage loans classified as held for sale are marked to fair value through earnings as part of the lower of cost or market value accounting policy. Finally, other instruments (such as guarantee obligations) are initially measured at fair value but are not remeasured at fair value on a periodic basis. These instruments affect earnings over time through the application of accounting policies addressing the amortization of these amounts into income and extinguishment when we purchase the related PCs and Structured Securities.

The assumptions used to determine or estimate fair values reflect our judgment regarding appropriate valuation methods. The selection of a method to estimate fair value for each type of financial instrument contemplates both the reliability and availability of relevant market data. The amount of management judgment involved in estimating the fair value of an instrument is affected by a number of factors, such as the type of financial instrument, the liquidity of the markets for the instrument, and the contractual characteristics of the instrument. For some instruments, actively quoted prices or pricing parameters (such as rates, spreads or volatilities) are available. The fair value of a substantial portion of our financial instruments is based on quoted prices or market parameters obtained from third-party pricing services or broker-dealers in active markets or is derived from such prices or parameters. Examples of these financial instruments include most mortgage-related securities, derivatives and all mortgage loans. Even for instruments with a high degree of price transparency, fair value estimation involves ongoing, significant judgment by us. These judgments include:

- Evaluation of the expected reliability;
- Reliability and timeliness and cost of alternative valuation methodologies;
- Selection of third-party market data sources;
- Selection of proxy instruments as necessary; and
- Adjustments to market-derived data to reflect differences in instruments' contractual terms.

While our general principle is to use consistent valuation methodologies over time, we periodically evaluate our methodologies and often change them to improve our fair value estimates or to accommodate market developments or changes in data availability.

Some of our financial instruments are not traded in active markets. Examples include guarantee assets, guarantee obligations and PC residuals. The fair value of these instruments is determined using internally developed models that facilitate simulation of multiple future scenarios that may occur. Material assumptions include:

- Projections of interest rates and housing prices; and
- Expectations about the resultant effects on prepayments, defaults and loss severity rates.

We also use significant judgment in incorporating market-implied option-adjusted spread data into our discount rates, including the selection of benchmark interest-only securities and the application of a trailing average option-adjusted spread assumption of up to 24 months. Similarly, the valuation of guarantee obligations involves the use of internal models incorporating empirical data coupled with the results of an effort to benchmark default and capital assumptions observed in comparable non-conforming securities market trades adjusted (as appropriate) to reflect differences in underlying collateral and other factors. Material assumptions include projections of credit losses (influenced by expectations about factors such as

defaults and loss severities) and expectations about the estimated risk premium needed to address exposure to unexpected increases in credit losses.

As described above, the determination of fair value often requires judgment and we might have reasonably chosen different methodologies or assumptions in the current period. The use of different pricing methodologies and assumptions could have produced materially different estimates of fair value in the periods currently presented. However, we believe the fair values we estimated are reasonable based on internal reviews of significant pricing models and methodologies as well as verification of financial instrument pricing with third party broker-dealers or pricing services. Furthermore, our estimates of fair value will change in future periods to reflect changes in market factors such as interest rates and related volatility, credit performance, expectations about prepayment behavior and other factors. Our estimates of fair value for individual instruments may change by material amounts, depending on market developments. See "RISK MANAGEMENT — Interest-Rate and Other Market Risks" for discussion of market risks and our interest-rate sensitivity disclosures, PMVS and duration gap.

Issuances and Transfers of Guaranteed Mortgage Securities

We purchase residential mortgage loans originated by mortgage lenders as well as mortgage-related securities. One of the means by which we fund purchases of mortgage loans is through the use of securitization-based financing. That is, we fund the purchases of such financial assets by issuing PCs, which are undivided interests in purchased mortgage loans, and transferring such PCs to investors in exchange for cash. We refer to securities that we issue through our resecuritization activities as Structured Securities which we issue through the resecuritization of PCs, non-Freddie Mac mortgage-related securities and other already issued Structured Securities. We commonly transfer Structured Securities to third parties in exchange for either cash or mortgage-related securities that third-party securities dealers deliver to us. We also provide a guarantee of the payment of principal and interest on tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties. These housing revenue bonds are collateralized by mortgage loans on low- and moderate-income multifamily housing projects. In addition, we guarantee the payment of principal and interest related to low- and moderate-income multifamily mortgage loans that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds. The unpaid principal amounts of the underlying mortgage loans are included in our definition of PCs and Structured Securities. We guarantee the payment of principal and interest on all issued PCs and Structured Securities. Mortgage-related assets that back PCs and Structured Securities held by third parties are not included in our consolidated financial statements. However, our obligation to provide the payment of principal and interest on issued PCs and Structured Securities usually results in the recognition of a guarantee asset and guarantee obligation on our consolidated balance sheets.

We evaluate whether transfers of PCs or Structured Securities qualify as sales based upon the requirements of SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" and, prior to April 1, 2001, SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," which we collectively refer to as SFAS 125/140. If we determine that a transfer of PCs or Structured Securities does not qualify as a sale, we account for such transfers as secured borrowings. If a transfer of PCs or Structured Securities qualifies as a sale, we recognize gain or loss on the sale immediately in earnings based upon the difference in value between cash received, the recognized carrying value of interests sold and the fair value of liabilities incurred upon sale. The determination of gain or loss on sale involves our best estimate of key assumptions, including expected credit losses and exposure to credit losses that could deviate from expected credit losses, prepayment rates, forward yield curves and discount rates. See "CRITICAL ACCOUNTING POLICIES — Fair Value" for further discussion concerning judgments made in connection with the valuation of guarantee assets and guarantee obligations.

Many of the transfers of PCs and Structured Securities that are made to third parties do not qualify as sales but are accounted for pursuant to the provisions of FIN 45. For such transactions, we recognize at the inception of an executed guarantee a guarantee obligation that is initially measured to be the greater of (a) fair value or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8 of SFAS No. 5, "Accounting For Contingencies," or SFAS 5. We also recognize the fair value of

any consideration received on such transactions. Positive differences between the fair value of consideration received and guarantee obligations incurred are deferred, while negative differences between such amounts are recognized immediately in earnings.

Table 11 summarizes securitization activity in 2003, 2002 and 2001.

Table 11 — Securitization Activity

	Year Ended		
	2003	2002	2001
	(dollars in millions)		
Transfers of Freddie Mac securities that were accounted for as sales	$347,874	$241,214	$158,166
Gain on sale[1]	711	874	311

(1) Subsequent to the issuance of our 2002 Information Statement dated February 27, 2004, we revised the amounts reported above for Gain on sale for the years ended December 31, 2002 and 2001, respectively, to conform previously reported amounts with methods used in 2003 to quantify gain on sale (as further discussed in "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to the consolidated financial statements). This revision had no impact on the consolidated financial statements.

The measurement of recognized guarantee assets, guarantee obligations and credit enhancement-related assets involves our best estimate of key assumptions, including expected credit losses and the exposure to credit losses that could be greater than expected credit losses, prepayment rates, forward yield curves and discount rates. We believe that the assumptions we made in this regard are comparable to those used by other market participants. The use of different pricing models and assumptions could produce materially different results. See "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to the consolidated financial statements for further discussion of methodologies we used to determine the fair values of guarantee assets and obligations.

Hedge Accounting

Our Retained portfolio activities and our funding of these investments with a mix of short- and long-term debt expose us to interest-rate risk and other market risks. In particular, a mortgage borrower's prepayment option makes the timing and amount of mortgage prepayments very sensitive to changes in interest rates. The borrower's option exposes us to a potential mismatch in cash inflows from the mortgage assets we purchase for investment as compared to cash outflows required to make payments on our debt. We manage this interest-rate risk through various investment and funding activities, as well as through the use of derivatives.

We recognize all derivatives, whether designated in hedging relationships or not, as either assets or liabilities on our consolidated balance sheets at fair value. Derivatives that are expected to be highly effective in reducing the risk associated with the exposure being hedged may be designated for accounting purposes as a hedge of the cash flows of a variable-rate instrument or a forecasted transaction (a cash flow hedge), a hedge of the changes in fair value of a fixed-rate instrument (a fair value hedge), or a foreign currency fair value or cash flow hedge (a foreign currency hedge). The change in fair value of derivatives that are not in hedge accounting relationships is reported in the consolidated statements of income in the period in which it occurs. The change in fair value of derivatives that are in cash flow hedging accounting relationships, to the extent these relationships are effective, is recorded as a separate component of AOCI, net of taxes, on the consolidated balance sheets and reclassified into the consolidated statements of income when the earnings effect of the hedged risk is recorded. The change in fair value of derivatives that are in fair value hedge accounting relationships is recorded each period in the consolidated statements of income, along with the change in fair value of the hedged item.

The determination of whether a derivative qualifies for hedge accounting requires judgment about the application of SFAS 133, as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities" and SFAS No. 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," which we collectively refer to as SFAS 133. SFAS 133 requires contemporaneous documentation of our hedge relationships, including the identification of the hedged item, the hedging instrument, the nature of the hedged risk and the method used to assess the effectiveness of the hedge relationship. We use statistical analysis or comparison of the critical terms of the hedging instrument to those

of the hedged item to assess the effectiveness of hedges. If our documentation and assessments are not adequate, the derivative does not qualify for hedge accounting. SFAS 133 also requires the periodic measurement and earnings recognition of the ineffective portion of the change in fair value of derivatives that are designated as part of hedge accounting relationships.

Derivatives designated as cash flow hedges generally hedge interest-rate risk related to forecasted issuances of debt. For these hedging relationships to qualify for hedge accounting, we must estimate the probable future level of certain types of debt issuances. These estimates are made based on our expectation of future funding needs and the future mix of funding sources. Our expectations about future funding are based upon projected growth and historical activity. If the estimates of future funding needs were to decrease or if the expected mix of debt funding were to become more concentrated in instruments that we did not designate in hedge accounting relationships, fewer derivatives could be designated as cash flow hedges and material amounts that we currently defer and report in AOCI would be reported in Derivatives gains (losses) in the consolidated statements of income. If our estimates of future funding are not realized, certain cash flow hedging relationships may no longer qualify for hedge accounting and material amounts that were deferred and reported in AOCI would be immediately recognized in Derivatives gains (losses) in the consolidated statements of income. We believe that the forecasted issuances of debt hedged in cash flow hedging relationships are probable of occurring.

Hedge accounting also requires us to measure hedge ineffectiveness and recognize it currently in the consolidated statements of income. For cash flow hedging relationships, we have elected to use the hypothetical derivative method, one of three methods acceptable under GAAP. This method requires us to develop a hypothetical derivative whose terms match those of the hedged item and compare estimated changes in it to changes in the hedging derivative. Development of this hypothetical derivative requires us to make certain assumptions and estimates. The use of different assumptions and estimates could result in a materially different amount of recorded ineffectiveness. We believe that our assumptions and estimates used to develop the hypothetical derivative are reasonable.

We use derivatives designated as fair value hedges generally to hedge interest-rate risk in existing debt instruments. Certain fair value hedging relationships are frequently terminated and started anew, or redesignated because the effectiveness of these relationships may deteriorate over time. When the hedge is terminated or redesignated, the fair value adjustment to the carrying amount of the hedged asset or liability is amortized to earnings as a component of the hedged item's interest income or expense over the remaining life of the hedged item using the effective yield method. In addition, a new hedging relationship may be formed. Thus, frequent redesignation may introduce material income statement volatility. Each time a hedging relationship is terminated and a new hedging relationship is formed, new documentation and assessments of effectiveness are required.

For a more detailed description of our use of derivatives and summaries of derivative positions, see "RISK MANAGEMENT — Interest-Rate and Other Market Risks — *Interest-Rate Risk Management and Use of Derivatives.*"

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

We maintain a Reserve for losses on mortgage loans held for investment to provide for credit losses incurred in that portfolio. At December 31, 2003 and 2002, the Reserve for losses on mortgages held for investment was $174 million and $177 million, respectively. The Reserve for losses on mortgage loans held for investment is determined pursuant to the provisions of SFAS 5 and SFAS No. 114, "Accounting by Creditors for Impairment of a Loan — an Amendment of FASB Statements No. 5 and 15," or SFAS 114. We also maintain a Reserve for guarantee losses on Participation Certificates to provide for losses incurred on mortgages underlying PCs or Structured Securities held by third parties. At December 31, 2003 and 2002, the Reserve for guarantee losses on Participation Certificates was $125 million and $88 million, respectively. The Reserve for guarantee losses on Participation Certificates is determined pursuant to the provisions of SFAS 5. The Reserve for losses on mortgage loans held for investment and the Reserve for guarantee losses on Participation Certificates are collectively referred to as the loan loss reserves. Increases in loan loss reserves that relate to both mortgage loans held in portfolio and PCs or Structured Securities held by third parties are

reflected in earnings as a component of the Provision for credit losses. Decreases in loan loss reserves are reflected through either (a) charging-off such balances (net of recoveries) where realized losses are recorded or (b) reducing Provision for credit losses.

Loan loss reserves are also increased upon the sale of PCs and Structured Securities for which we incurred losses on the underlying mortgage loans while such securities were held in portfolio. From an earnings perspective, such incurred losses are recognized as a component of Gains (losses) on investment activity through, where applicable, (a) the subsequent measurement of corresponding PC residuals that are classified as trading (and to which such PCs or Structured Securities relate), (b) the recognition of impairment-related losses on such securities (i.e., to the extent that such securities do not have recognized PC residual balances associated with them that are classified as trading) or (c) as a component of gain (loss) on sale of such securities. In this regard, and upon the sale of such PCs or Structured Securities, incurred losses are classified on the consolidated balance sheets as Reserve for guarantee losses on Participation Certificates. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Recently Adopted Accounting Standards and Accounting Changes — *Accounting for Financial Guarantees*," to the consolidated financial statements for a discussion of the impact of newly adopted accounting standards on the loan loss reserves in 2003. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" and "NOTE 6: LOAN LOSS RESERVES" to the consolidated financial statements for more information about our process for determining the loan loss reserves.

The process for determining the level of loan loss reserves is subject to numerous estimates and assumptions that are highly uncertain and require a high degree of judgment. The underlying estimates and assumptions used in determining the loan loss reserves are regularly evaluated by us and updated to reflect our own historical experience and our current view of overall economic conditions and other relevant factors. Changes in one or more of these underlying estimates and assumptions could have a material impact on the loan loss reserves and the provision for credit losses. The degree to which a change in these estimates and assumptions impacts the loan loss reserves is dependent upon the significance of such change. Key estimates and assumptions that could have an impact on loan loss reserves include:

- Loss severity trends;
- Default experience;
- Expected proceeds from credit enhancements;
- Evaluation of collateral; and
- Identification of relevant macroeconomic factors and assessment of their applications.

The factors we have chosen are based on all available information and our knowledge and experience in the single-family and multifamily loan markets. As a significant amount of judgment is exercised in selecting these factors, had we made different determinations in the selection of these factors, a materially different level of loan loss reserves could have resulted. Additionally, it is possible that others, given the same information, could have reached different reasonable conclusions. However, we believe the level of loan loss reserves are reasonable based on internal reviews of the factors and methodologies used. Actual credit loss experience could differ from our current estimates.

Table 12 summarizes the activity in loan loss reserves in 2003 and 2002.

Table 12 — Loan Loss Reserves

	December 31,	
	2003	2002
	(dollars in millions)	
Beginning balance	$265	$ 224
Provision for credit losses	10	128
Charge-offs	(224)	(171)
Recoveries[1]	119	84
Charge-offs, net	(105)	(87)
Adjustment for change in accounting[2]	110	—
Transfers-in during the period[3]	19	—
Ending balance	$299	$ 265

(1) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where the primary default risk has been assumed by servicers, mortgage insurers, or third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in many instances to amounts less than the full amount of the loss.
(2) On January 1, 2003, that portion of recognized guarantee obligations that was attributable to estimated incurred losses on outstanding PCs or Structured Securities, of $110 million, was reclassified to Reserve for guarantee losses on Participation Certificates.
(3) Represents estimated losses that were incurred in 2003 related to PCs and Structured Securities transferred to third parties in 2003.

Interest Income Recognition and Impairment Recognition

For most of our investments in mortgage-related securities and non-mortgage related securities, interest income is recognized using the effective interest method in accordance with SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases," or SFAS 91. Deferred items, including premiums, discounts and other basis adjustments such as changes in commitment-period fair value, are amortized into interest income over the estimated lives of the securities using the retrospective effective interest method in accordance with SFAS 91. Under the retrospective method, we recalculate the constant effective yield based on changes in estimated prepayments and actual prepayments versus anticipated prepayments. Catch-up adjustments to the unamortized balance of premiums, discounts and other deferred items that result from applying the updated effective yield as if it had been in effect since acquisition are recognized through interest income. For certain other investments in mortgage-related securities and non-mortgage-related securities classified as available for sale, interest income is recognized using the prospective effective interest method in accordance with EITF No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," or EITF 99-20. Under the prospective method, changes in the effective yield are recognized as adjustments to interest income in future periods. We specifically apply such guidance to beneficial interests (including undivided interests which are similar to beneficial interests) in securitized financial assets that:

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

We use actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method of income recognition. In estimating future prepayments and cash flows, we aggregate securities by similar characteristics of their underlying collateral such as origination date, coupon and maturity. For securities with structured cash flow payments, such as Structured Securities we also consider the characteristics of other security classes within the same transaction structure when estimating future prepayments and cash flows. Estimates of future prepayments are derived from market sources and prepayment models. Determination of the effective yield requires significant judgment in estimating expected prepayment behavior, which is inherently uncertain. Our prepayment models contemplate a variety of assumptions about borrower behavior in response to changes in interest rates and other macroeconomic factors. Judgment is involved in making initial determinations about prepayment expectations and in changing those expectations over time in response to changes in market conditions. The effects of future

changes in market conditions may be material. We believe that the above assumptions are comparable to those used by other market participants. However, the use of different assumptions in our prepayment models could have resulted in materially different income recognition results.

We recognize impairment losses on available-for-sale securities in our Retained portfolio and cash and investments portfolio when we have concluded that a decrease in the fair value of a security is other than temporary. More specifically, EITF 99-20 requires impairment recognition when there is both a decline in fair value below the carrying amount and an adverse change in expected cash flows. Determination of whether an adverse change has occurred involves judgment about expected prepayments and credit events. For securities not accounted for under EITF 99-20, we review securities for possible other-than-temporary impairment when a security meets one or more of a series of objective criteria relative to its fair value compared to its amortized cost, credit ratings, the amount of time the investment has been in an unrealized loss position, or if we otherwise believe that an unrealized loss is other than temporary based on qualitative indicators of potential impairment. We apply significant judgment in selecting these objective criteria and in otherwise determining whether impairment loss recognition is appropriate. We believe our judgments are reasonable; however, different judgments could have resulted in materially different impairment loss recognition.

See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for a discussion of the potential impact of EITF 03-1.

Accounting Changes and Future Application of Accounting Standards

See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for more information concerning accounting changes and new accounting pronouncements.

CONSOLIDATED RESULTS OF OPERATIONS

MD&A, and the following discussion of our consolidated results of operations in particular, should be read in conjunction with the notes to our consolidated financial statements.

Table 13 summarizes our financial performance for the periods presented.

Table 13 — Summary of Consolidated Results

	2003 vs. 2002				2002 vs. 2001		
	Year Ended December 31,		Change		Year Ended December 31,	Change	
	2003	2002	Dollar	Percent	2001	Dollar	Percent
	(in millions, except per share amounts)						
Net interest income	$ 9,498	$ 9,525	$ (27)	—%	$ 7,448	$ 2,077	28%
Non-interest income (loss)							
Management and guarantee income	1,638	1,516	122	8	1,392	124	9
Gains (losses) on "Guarantee asset for Participation Certificates, at fair value"	(1,461)	(2,176)	715	(33)	(789)	(1,387)	176
Income (expense) on "Guarantee obligation for Participation Certificates"	925	592	333	56	203	389	192
Derivative gains (losses)	39	5,302	(5,263)	(99)	(2,313)	7,615	(329)
Hedge accounting gains (losses)	644	187	457	244	(294)	481	(164)
Gains (losses) on investment activity	(1,114)	1,799	(2,913)	(162)	191	1,608	842
Gains (losses) on debt retirement	(1,775)	(674)	(1,101)	163	(356)	(318)	89
Resecuritization fees	352	276	76	28	135	141	104
Other income	493	321	172	54	229	92	40
Total non-interest income (loss)	(259)	7,143	(7,402)	(104)	(1,602)	8,745	(546)
Non-interest expense							
Provision for credit losses	(10)	(128)	118	(92)	(32)	(96)	300
REO operations income (expense)	23	13	10	77	(7)	20	(286)
Salaries and employee benefits	(624)	(593)	(31)	5	(537)	(56)	10
Occupancy expense	(52)	(42)	(10)	24	(35)	(7)	20
Housing tax credit partnerships	(200)	(160)	(40)	25	(121)	(39)	32
Minority interest in earnings of consolidated subsidiaries	(157)	(184)	27	(15)	(208)	24	(12)
Other expenses	(1,201)	(771)	(430)	56	(452)	(319)	71
Total non-interest expense	(2,221)	(1,865)	(356)	19	(1,392)	(473)	34
Income before income tax expense and cumulative effect of change in accounting principles	7,018	14,803	(7,785)	(53)	4,454	10,349	232
Income tax expense	(2,202)	(4,713)	2,511	(53)	(1,339)	(3,374)	252
Income before cumulative effect of change in accounting principles, net of taxes	4,816	10,090	(5,274)	(52)	3,115	6,975	224
Cumulative effect of change in accounting principles, net of taxes	—	—	—	—	43	(43)	(100)
Net income	4,816	10,090	(5,274)	(52)	3,158	6,932	220
Preferred stock dividends and issuance costs on redeemed preferred stock[1]	(216)	(239)	23	(10)	(217)	(22)	10
Net income available to common stockholders[1]	$ 4,600	$ 9,851	$(5,251)	(53)%	$ 2,941	$ 6,910	235%
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes[1]	$ 6.68	$ 14.17	$ (7.49)	(53)%	$ 4.23	$ 9.94	235%

(1) In accordance with the requirements of EITF D-42, we restated the 2002 amount of Preferred stock dividends and issuance costs on redeemed preferred stock reported on our consolidated statements of income. For the year ended December 31, 2002, the restatement increased by $5 million the amount representing issuance costs on redeemed preferred stock and therefore reduced Net income available to common stockholders by $5 million. This caused a reduction in both basic and diluted earnings per share for the same year of $0.01 per share. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Recently Issued Accounting Standards" to the consolidated financial statements for additional information.

Net Interest Income

Net interest income, our principal source of earnings, represents the difference between interest income and interest expense. Net interest income is affected by changes in the balance and contractual rates associated with our interest-bearing assets, liabilities and derivative contracts, as adjusted for amortization of premiums and discounts and amortization of deferred hedging gains and losses as explained later in "Analysis of Quarterly Results." We analyze net interest income, and the related net interest yield, on a taxable-equivalent basis to consistently reflect income from taxable and tax-exempt investments based on a 35 percent marginal tax rate.

In 2003, in accordance with interpretive guidance published by the Office of the Chief Accountant of the SEC, we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in hedge accounting relationships from Income (expense) related to derivatives, a component of Net interest income, to Derivative gains (losses), a component of Non-interest income (loss). These amounts have also been reclassified in all prior periods to conform to the 2003 presentation.

2003 versus 2002

Table 14 summarizes net interest income for 2003 compared to 2002, and the related analysis of the effect of changes in the rates and volumes of our interest-bearing assets and liabilities on the changes in net interest income between 2003 and 2002.

Table 14 — Net Interest Income and Rate/Volume Analysis (2003 compared to 2002)

	2003		2002		Increase (Decrease)	Attributable to Changes in[1]	
	Amount	Yield	Amount	Yield	to Amount	Rate	Volume
	(dollars in millions)						
Interest income:							
Mortgage loans	$ 4,251	6.70%	$ 4,290	7.02%	$ (39)	$ (199)	$ 160
Mortgage-related securities[2]	29,051	5.34	30,039	6.39	(988)	(5,330)	4,342
Total Retained portfolio	33,302	5.48	34,329	6.46	(1,027)	(5,529)	4,502
Cash and investments	3,796	2.63	4,147	3.41	(351)	(718)	367
Total interest-earning assets	37,098	4.93	38,476	5.89	(1,378)	(6,247)	4,869
Interest expense:							
Short-term debt	(2,785)	(1.21)	(4,303)	(2.03)	1,518	1,849	(331)
Long-term debt	(22,083)	(4.62)	(21,337)	(5.24)	(746)	2,725	(3,471)
Total interest expense on debt securities	(24,868)	(3.52)	(25,640)	(4.15)	772	4,574	(3,802)
Due to Participation Certificate investors	(1,641)	(6.26)	(1,236)	(6.82)	(405)	110	(515)
Total expense on interest-bearing liabilities	(26,509)	(3.62)	(26,876)	(4.23)	367	4,684	(4,317)
Income (expense) related to derivatives[3]	(1,091)	(0.15)	(2,075)	(0.32)	984	984	—
Impact of net non-interest-bearing funding	—	0.10	—	0.13	—	—	—
Net interest income[3][4]	9,498	1.27	9,525	1.46	(27)	(579)	552
Fully taxable-equivalent adjustment	227	0.03	252	0.04	(25)	9	(34)
Net interest income (fully taxable-equivalent basis)[3][4]	$ 9,725	1.30%	$ 9,777	1.50%	$ (52)	$ (570)	$ 518

(1) Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.
(2) Subsequent to the announcement of our 2003 financial results in our Information Statement Supplement dated June 30, 2004, we revised the average balances of Mortgage-related securities in the Retained portfolio to include certain basis adjustments related to these securities. This revision resulted in a decrease to the Average Balance of Mortgage-related securities in the Retained portfolio of $112 million and $175 million for the years 2003 and 2002, respectively, as well as an increase of 0.01 percent to the 2002 Yield related to Mortgage-related securities in the Retained portfolio. This revision also resulted in corresponding changes to the related Rate/Volume Analysis.
(3) In 2003 we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in hedge accounting relationships from Income (expense) related to derivatives to Derivative gains (losses). For comparative purposes, we reclassified $639 million of expense from Income (expense) related to derivatives to Derivative gains (losses) in 2002.
(4) May not sum due to rounding.

Net interest income on a fully taxable-equivalent basis decreased by $52 million to $9,725 million in 2003 from $9,777 million in 2002. During 2003, interest income on mortgage-related securities declined by $988 million, or 3 percent. The interest income generated by the 14 percent growth in the unpaid principal balance of the Retained portfolio was more than offset by the accelerated amortization of higher net premiums on these securities, lower yields on assets acquired due to the low interest rate environment during 2003, and the continued liquidation of higher-yielding assets during 2003. Net interest income and net interest yield were reduced as the yield on interest-earning assets declined at a faster rate than the cost of debt funding during 2003. During the first quarter of 2003, we refined the assumptions and calculations for the amortization of deferred fees recorded as discounts on assets in our Retained portfolio. The effect on net interest income of refining these assumptions, which was treated as a change in estimate, was the recognition of $31 million of additional amortization income during the first quarter of 2003. As discussed below, these refined assumptions

also affected management and guarantee fee income. Interest income related to cash and investments declined by $351 million, or 8 percent, during 2003 as the negative impact of declining interest rates during the first half of 2003 was only partially offset by the 19 percent increase in the average balances of cash and investments during 2003.

The decline in short-term interest rates during the first half of 2003 was the primary factor in the decline in interest expense related to short-term debt for the year of $1,518 million, or 35 percent, which was only partially offset by an 8 percent increase in the average balances of short-term debt during the year. Interest expense related to long-term debt increased by $746 million, or 3 percent, during 2003 as the average balances of long-term debt increased by 17 percent, which offset the benefit of issuing new debt at lower rates. We repurchased approximately $27 billion of long-term debt during 2003 and issued new debt at lower average rates in most cases. The most significant debt repurchases in 2003 occurred in the second quarter when we repurchased an aggregate of approximately $17 billion of U.S. dollar and Euro-denominated debt securities, most of which followed the announcement of changes in our senior management. We executed these particular repurchases in an effort to support the liquidity and price performance of these securities. Gains and losses on debt retirement are reported as a component of Non-interest income (loss).

Interest expense related to amounts due to PC investors increased by $405 million to ($1,641) million in 2003 from ($1,236) million in 2002 as prepayments on the collateral underlying PCs accelerated during the first part of 2003 in response to declining interest rates. The liquidation rate on outstanding PCs and Structured Securities increased to 63 percent in 2003 from 47 percent in 2002. For a further discussion of how the prepayments of the collateral underlying PCs affect net interest income, see "Analysis of Quarterly Results — Interest Expense Related to Amounts Due to Participation Certificate Investors."

Income (expense) related to derivatives, which includes the accrual of periodic cash settlements on interest-rate swap transactions accounted for as hedges and amortization of net deferred losses on closed cash flow hedges, improved by $984 million, decreasing to ($1,091) million in 2003 from ($2,075) million in 2002. During 2002 and into 2003, we terminated pay-fixed swaps to help manage the funding mismatch caused by the decrease in the expected lives of mortgage investments and an increase in the balance of long-term debt. In 2002, the portfolio of swaps designated in hedge accounting relationships was in a net pay-fixed position, which resulted in increasing interest expense as market interest rates declined.

Net interest yield on a fully taxable-equivalent basis decreased by 20 basis points to 130 basis points in 2003 from 150 basis points in 2002. For 2003, net interest yield was lower as declines in yields on interest-earning assets outpaced the benefit of lower funding costs. The net interest yield on interest-earning assets declined as a result of high liquidations in the first three quarters of 2003 and the acquisition of new assets in a lower rate environment. The net interest yield on debt securities declined as the result of our long-term debt retirements, primarily in the second quarter of 2003, and subsequent refinance activity, primarily decreasing our short-term funding costs. Overall net interest yield declined as our interest-earning assets repriced faster than our debt.

2002 versus 2001

Table 15 summarizes net interest income for 2002 compared to 2001, and the related rate/volume analysis for the changes between 2002 and 2001.

Table 15 — Net Interest Income and Rate/Volume Analysis (2002 compared to 2001)

	2002		2001		Increase (Decrease) to Amount	Attributable to Changes in[1]	
	Amount	Yield	Amount	Yield		Rate	Volume
	(dollars in millions)						
Interest income:							
Mortgage loans	$ 4,290	7.02%	$ 4,385	7.22%	$ (95)	$ (118)	$ 23
Mortgage-related securities[2]	30,039	6.39	26,847	6.92	3,192	(2,201)	5,393
Total Retained portfolio	34,329	6.46	31,232	6.96	3,097	(2,319)	5,416
Cash and investments	4,147	3.41	4,136	4.82	11	(1,448)	1,459
Total interest-earning assets	38,476	5.89	35,368	6.62	3,108	(3,767)	6,875
Interest expense:							
Short-term debt	(4,303)	(2.03)	(9,056)	(4.23)	4,753	4,670	83
Long-term debt	(21,337)	(5.24)	(17,494)	(6.00)	(3,843)	2,416	(6,259)
Total interest expense on debt securities	(25,640)	(4.15)	(26,550)	(5.25)	910	7,086	(6,176)
Due to Participation Certificate investors	(1,236)	(6.82)	(1,027)	(7.27)	(209)	66	(275)
Total expense on interest-bearing liabilities	(26,876)	(4.23)	(27,577)	(5.31)	701	7,152	(6,451)
Income (expense) related to derivatives[3]	(2,075)	(0.32)	(343)	(0.07)	(1,732)	(1,732)	—
Impact of net non-interest-bearing funding	—	0.13	—	0.17	—	—	—
Net interest income[3][4]	9,525	1.46	7,448	1.41	2,077	1,653	424
Fully taxable-equivalent adjustment	252	0.04	237	0.04	15	4	11
Net interest income (fully taxable-equivalent basis)[3][4]	$ 9,777	1.50%	$ 7,685	1.45%	$ 2,092	$ 1,657	$ 435

(1) Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.
(2) Subsequent to the announcement of our 2003 financial results in our Information Statement Supplement dated June 30, 2004, we revised the average balances of Mortgage-related securities in the Retained portfolio to include certain basis adjustments related to these securities. This revision resulted in a decrease to the Average Balance of Mortgage-related securities in the Retained portfolio of $175 million and $121 million for the years 2002 and 2001, respectively, as well as an increase of 0.01 percent to the 2002 Yield related to Mortgage-related securities in the Retained portfolio. This revision also resulted in corresponding changes to the related Rate/Volume Analysis.
(3) In 2003 we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in hedge accounting relationships from Income (expense) related to derivatives to Derivative gains (losses). For comparative purposes, we reclassified $639 million and $456 million of expense from Income (expense) related to derivatives to Derivative gains (losses) in 2002 and 2001, respectively.
(4) May not sum due to rounding.

Net interest income on a fully taxable-equivalent basis increased $2,092 million, or 27 percent, to $9,777 million in 2002 from $7,685 million in 2001. The increase in net interest income was primarily due to a continuation during 2002 of the steep yield curve environment that existed in 2001. A steepening yield curve means that short-term interest rates are decreasing more than long-term rates, or are increasing at a slower rate than long-term rates. The decrease in short-term interest rates during 2002 coupled with the steepening yield curve resulted in a reduction in short-term debt costs and wider initial mortgage-to-debt spreads on additions to the Retained portfolio. An increase of $83 billion, or 18 percent, in the average balance of the Retained portfolio in 2002 also contributed to the increase in net interest income. See "CONSOLIDATED BALANCE SHEETS ANALYSIS — Retained Portfolio" for a discussion regarding changes in the balance of the Retained portfolio.

The positive effects of the steep yield curve and Retained portfolio growth on net interest income were offset by higher expenses related to the accrual of periodic cash settlements of derivatives in hedge accounting relationships and increased amortization expense associated with (1) net premiums on mortgage-related investments and (2) deferred hedging losses related to terminated pay-fixed swaps recorded in AOCI. The increase in amortization expense was caused by decreases in long-term rates during 2002, which shortened the expected lives of mortgage-related investments resulting in accelerated amortization of related premiums. In addition, we terminated pay-fixed swaps in cash flow hedge accounting relationships in loss positions, resulting in increased amortization expense related to closed hedge positions. As discussed in "CONSOLIDATED BALANCE SHEETS ANALYSIS — Total Debt Securities, Net," the termination of these pay-fixed swaps shortened the effective duration of our liabilities to address the decrease in the expected lives of mortgage investments. For further information regarding amortization of premiums, discounts and hedging gains and losses, see "Analysis of Quarterly Results" below.

Net interest yield on a fully taxable-equivalent basis increased by 5 basis points to 150 basis points in 2002 from 145 basis points in 2001. This relatively small change in net interest yield was the net result of the effects of the steep yield curve, increased amortization expense and the shift in the mix of interest-earning assets toward cash and investments which typically generates relatively lower yields. The average balance of cash and investments increased by 42 percent, fueled by cash inflows from prepayments on outstanding PCs. Limited Retained portfolio investment opportunities during certain periods of 2002 also contributed to growth in the average balance of cash and investments.

Analysis of Quarterly Results

Table 16 summarizes quarterly net interest income and net interest yield for 2003 and 2002.

Table 16 — Quarterly Net Interest Income (quarterly yields annualized)

	1Q 2003	2Q 2003	3Q 2003	4Q 2003	2003
			(dollars in millions)		
Net interest income	$2,421	$2,185	$2,442	$2,450	$9,498
Fully taxable-equivalent adjustment	41	64	60	62	227
Net interest income (fully taxable-equivalent basis)	$2,462	$2,249	$2,502	$2,512	$9,725
Net interest yield (fully taxable-equivalent basis)	1.40%	1.26%	1.27%	1.26%	1.30%

	1Q 2002	2Q 2002	3Q 2002	4Q 2002	2002
			(dollars in millions)		
Net interest income[1]	$2,544	$2,352	$2,231	$2,398	$9,525
Fully taxable-equivalent adjustment	66	65	66	55	252
Net interest income (fully taxable-equivalent basis)[1]	$2,610	$2,417	$2,297	$2,453	$9,777
Net interest yield (fully taxable-equivalent basis)[1]	1.67%	1.53%	1.41%	1.41%	1.50%

(1) In 2003 we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in hedge accounting relationships from Income (expense) related to derivatives to Derivative gains (losses). For comparative purposes, we reclassified expense of $130 million, $229 million, $152 million and $128 million for the first, second, third and fourth quarters of 2002, respectively, and $639 million for full-year 2002 from Income (expense) related to derivatives to Derivative gains (losses).

Changes in quarterly net interest income and net interest yield in 2003 and 2002 were driven primarily by changes in interest rates and growth in the Retained portfolio, as described above in the analysis of annual results. Other drivers of net interest income and yields are described in detail below, followed by a tabular presentation (see "Table 17 — Explanation of Quarterly Changes in Net Interest Income and Net Interest Yield") discussing the impact of these drivers on net interest income during the quarterly periods of 2003 and 2002.

- **Investment asset mix.** The purchase, sale and liquidation activity of assets within the Retained portfolio and the cash and investments portfolio, which we collectively refer to as our portfolios,

has a significant impact on our overall net interest yield. As the composition of the portfolios changes between higher or lower yielding asset types, the overall net asset yield on these portfolios fluctuates. Generally, during periods of declining interest rates, as we experienced in 2002 and the first half of 2003, the yield on portfolio assets will decline as higher-yielding assets liquidate and new assets are acquired at lower rates. The opposite effect is generally seen when interest rates rise, as the pace of liquidations slows and new assets are acquired at higher rates. Changes in the interest yields of our portfolios occur when there is a shift in the proportion of higher-yielding asset types to lower-yielding asset types. For example, the mortgage-related securities portfolio net interest yield will decline if there is an increase in the amount of lower-yielding mortgages such as 15-year mortgages or ARMs as compared to higher-yielding 30-year fixed-rate loans.

- **Amortization of premiums and discounts.** When we purchase mortgage-related securities, the price we pay for the assets generally does not equal the securities' unpaid principal balance. We pay more than the unpaid principal balance (referred to as a premium) when the coupon on the security is greater than the current market yield for that security. We pay less than the unpaid principal balance (referred to as a discount) when the coupon on the security is less than the current market yield for that security. As interest rates declined during 2002 and the first half of 2003, the total premiums we paid increased on the mortgage-related securities we acquired. This resulted in a shift in the portfolios to a net premium position late in 2002, and an increasing premium position in 2003.

  Premiums and discounts are amortized over the estimated life of the purchased assets as adjustments to interest income primarily based on the effective interest method in accordance with SFAS 91. This method of amortization results in periodic adjustments to interest income when the effective interest rate changes due to differences between actual and estimated prepayments and changes in estimated future prepayments.

- **Amortization of hedging gains and losses.** Certain derivative contracts (primarily pay-fixed swaps) are accounted for as cash flow hedges of the variability of interest payments on forecasted debt issuances, while other derivative contracts (primarily receive-fixed swaps) are accounted for as fair value hedges of existing debt. In both cases, termination of the hedge accounting relationship results in the associated deferred hedging gain or loss being amortized into net interest income. Amortization related to terminated cash flow hedges is included in Income (expense) related to derivatives or, if the deferred gain or loss is related to a closed cash flow hedge on long-term debt, in Interest expense on long-term debt. The amortization related to terminated fair value hedges is also included in Interest expense on long-term debt.

- **Interest expense related to amounts due to PC investors**. As a result of the payment remittance cycle associated with PCs, interest expense related to amounts due to PC investors tends to increase during periods of rising prepayments and decrease during periods of declining prepayments. We invest the proceeds from prepayments on PCs in short-term investments until related payments are due to PC investors. The interest earned on these investments is reported as a component of interest income on cash and investments. As short-term rates declined in 2002 and the first half of 2003, prepayments accelerated due to a decline in mortgage rates and our interest costs due to PC investors increased while the interest earnings on our related investments declined. This had an overall negative impact on "Net interest income."

- **Debt funding mix.** As discussed in "CONSOLIDATED BALANCE SHEETS ANALYSIS — Total Debt Securities, Net," we adjust the composition of our derivative portfolio to address differences between outstanding debt, scheduled debt issuances and our funding needs. Due to declining interest rates in 2002 and the first half of 2003, the expected lives of assets held in the Retained portfolio decreased, requiring us to reduce the duration of our long-term debt funding from an asset/liability management perspective. However, the volume of long-term debt issued is generally determined by our commitment to our Reference Notes® securities calendar. In 2002 and the first half of 2003, we terminated certain pay-fixed swaps and entered into receive-fixed swaps to shorten the effective duration of our debt and thereby manage the funding

mismatch created by the decline in interest rates. Receive-fixed swaps effectively convert a fixed-rate debt payment into a variable-rate payment. Conversely, a pay-fixed swap requires us to make a fixed interest payment in exchange for a variable rate payment. In the third quarter of 2003, we entered into additional pay-fixed swaps to extend the duration of our debt portfolio as interest rates increased.

Table 17 describes the effect of these factors on changes in quarterly net interest income on a fully taxable-equivalent basis.

Table 17 — Explanation of Quarterly Changes in Net Interest Income and Net Interest Yield

Period	Increase (Decrease) in Net Interest Income (in millions)	Increase (Decrease) in Net Interest Yield (in bps)	Comments
2Q02 vs. 1Q02	$(193)	(14)	Decreases were driven by a continued shift in debt funding from short-term debt to long-term debt and increased amortization of deferred hedging losses resulting from terminated pay-fixed swaps, as described above in "Debt funding mix."
3Q02 vs. 2Q02	(120)	(12)	Decreases were due to increased amortization expense related to deferred premiums on Retained portfolio purchases and deferred hedging losses associated with terminated pay-fixed swaps. As discussed above in "Amortization of premiums and discounts," the deferred amount related to the Retained portfolio shifted to a net premium position late in 2002. The associated increase in amortization expense was partially offset by an increase in interest income from derivative contracts as a result of increases in the notional amount of receive-fixed swaps in hedge accounting relationships.
4Q02 vs. 3Q02	156	—	The increase in net interest income was driven by the recognition of amortization income in the fourth quarter as compared to expense in the third quarter and interest income on derivative contracts, partially offset by increased interest expense related to amounts due to PC investors. The increase in amortization income was primarily due to a $305 million adjustment related to enhancements made in the fourth quarter of 2002 to our method of estimating prepayments of the collateral underlying our mortgage-related securities. The increase in interest income on derivative contracts was due to an increase in the notional amount of receive-fixed swaps. Interest expense on amounts due to PC investors increased as the liquidation rate on total PCs issued increased in the fourth quarter of 2002.
1Q03 vs. 4Q02	9	(1)	The increase in net interest income related to a decrease in short-term debt expense as a result of declining interest rates and higher interest income related to derivatives due to an increase in volume of receive-fixed swaps. Partially offsetting these increases was higher amortization expense related to net deferred premiums on mortgage investment purchases. In addition, lower yields were recognized on the investment portfolio as short-term rates remained low. During the first quarter of 2003, we refined the assumptions and calculations for the amortization of deferred fees recorded as discounts on assets in our Retained portfolio. The effect on net interest income of refining these assumptions, which was treated as a change in estimate (and which also impacted management and guarantee income) was the recognition of $31 million of additional amortization income during the first quarter of 2003. Although yields on assets were declining faster than debt costs, the margin reduction was offset by the rate impact of lower derivative expenses.

Table 17 — Explanation of Quarterly Changes in Net Interest Income and Net Interest Yield (continued)

Period	Increase (Decrease) in Net Interest Income (in millions)	Increase (Decrease) in Net Interest Yield (in bps)	Comments
2Q03 vs. 1Q03	$(213)	(14)	Decreases were driven by increases in amortization expense related to deferred premiums on mortgage investment purchases. As discussed above in "Amortization of premiums and discounts," the deferred amount related to the total Retained portfolio was in an increasing net premium position and liquidations increased in the quarter. Also, increased liquidations on PCs outstanding generated timing differences between amounts due from servicers and amounts due to PC investors resulting in increased interest expense. The liquidation rate on total PCs issued increased from 59 percent in the first quarter of 2003 to 74 percent in the second quarter of 2003. Partially offsetting the negative effects above was lower long-term debt expense due to large debt retirements completed in the second quarter. Net interest yield declined as amortization expenses and lower asset yields outpaced lower funding costs.
3Q03 vs. 2Q03	253	1	Increases were driven by lower amortization expense resulting from adjustments to the amortization of the related deferred premiums in the Retained portfolio as mortgage rates and estimates of weighted average mortgage lives increased. Net interest income also benefited from decreases in long-term debt expense and net growth in the Retained portfolio. Interest expense on derivative contracts increased with purchases of additional pay-fixed swaps typically acquired in a rising rate environment, which were designated in hedge accounting relationships. Net interest yield remained relatively flat as the decline in our debt costs was offset by the decline in asset yields and an increase in expense related to derivatives.
4Q03 vs. 3Q03	10	(1)	Increases to net interest income were due to increased interest income recognized on the mortgage investment portfolio as the average balance of the Retained portfolio increased by 5 percent quarter-over-quarter, offset by increased long-term debt expense related to the funding of the Retained portfolio growth. Net interest yield remained relatively flat as improved funding costs were offset by lower asset yields.

Non-Interest Income (Loss)

Management and Guarantee Income

Management and guarantee income primarily represents the contractual guarantee fees we receive on mortgage-related securities issued and guaranteed by us and held by third party investors. For securities we hold, the associated components of guarantee income are included in Net interest income. Management and guarantee income also includes amortization of deferred fees, including credit fees and buy-down fees on these securities if they had not previously been sold under SFAS 125/140, or previously been subject to guarantee accounting under FIN 45.

Table 18 provides summary information about management and guarantee income for 2003, 2002 and 2001. The total management and guarantee rate consists of the contractual management and guarantee fee rate as adjusted for amortization of deferred fees, including credit fees and buy-down fees.

Table 18 — Management and Guarantee Income

	2003		2002		2001	
	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)					
Contractual management and guarantee fees	$ 1,229	17.3	$ 1,335	19.4	$ 1,277	21.7
Amortization of deferred fees	409	5.7	181	2.6	115	1.9
Total management and guarantee income	$ 1,638	23.0	$ 1,516	22.0	$ 1,392	23.6

Management and guarantee income increased by $122 million, or 8 percent, to $1,638 million in 2003 from $1,516 million in 2002. This increase in guarantee income was driven by a 3 percent increase in average outstanding PCs and an increase in the average total management and guarantee rate recognized in 2003, which includes amortization of deferred fees.

The total management and guarantee rate recognized in 2003 was 23.0 basis points compared with 22.0 basis points in 2002. The increase in the total management and guarantee rate between 2003 and 2002 was driven by accelerated amortization of deferred fees, partially offset by lower contractual management and guarantee fee rates on new business. Deferred fees are amortized over the estimated life of the mortgages underlying PCs using the effective interest method (as established by SFAS 91) and periodic adjustments to deferred fee amortization are made to reflect differences between actual and estimated mortgage prepayments and changes in estimated future prepayments. Increased amortization of deferred fees resulted from the decline in mortgage interest rates during the first half of 2003 and the related increase in mortgage prepayments, as well as a first quarter 2003 change in the prepayment models we used to determine the weighted average lives of outstanding PCs (as discussed below).

In the first quarter of 2003, we improved our methodology for estimating the expected weighted average lives of mortgages with related deferred fees, including credit fees and buy-down fees. The change in estimate included enhancements to the prepayment models we use to determine the expected weighted average lives of mortgage loans underlying our PCs, which in turn are used to calculate the recognition of deferred fees based on the effective interest method. Under this method, we use actual prepayment experience and estimates of future prepayments to determine, and subsequently adjust, a constant yield necessary to properly apply the effective interest method. These improvements to our models were treated as a change in estimate in accordance with Accounting Principles Board Opinion No. 20, "Accounting Changes", and resulted in the recognition of $110 million of additional amortization income in management and guarantee income in the first quarter of 2003.

The accelerated amortization of deferred fees in 2003 was partially offset by a decline in the contractual guarantee fees received in 2003. The decline in contractual guarantee fees received was driven generally by portfolio turnover, resulting in a decrease in the average contractual guarantee fee rate to 17.3 basis points in 2003 from 19.4 basis points in 2002. The portfolio turnover in 2003 was characterized by decreases in rates on new guarantees, as well as high turnover of seasoned loans with rates higher than the portfolio average. The decrease in contractual rates on new guarantees was driven by (a) an increase in the issuance of 15-year PCs, which generally have lower credit risk and, thus, a lower management and guarantee fee rate relative to 30-year PCs and (b) competitive pricing pressures. Turnover of seasoned loans with higher contractual rates resulted in a decrease in the proportion of loans with buy-ups. Buy-ups are upfront payments we make that increase the contractual guarantee fees that we receive over the life of the PC in connection with our guarantee.

As of December 31, 2003 and 2002, 81 percent and 54 percent, respectively, of outstanding PCs and Structured Securities had a corresponding guarantee asset and guarantee obligation. The percentage increase results from the recognition of guarantee assets and guarantee obligations on PCs issued through the Guarantor Program in accordance with FIN 45, which was adopted in 2003. See "NOTE 1: SUMMARY OF

SIGNIFICANT ACCOUNTING POLICIES" to our consolidated financial statements for more information. Deferred fees related to these securities have either been recognized in earnings in connection with a PC sales transaction or included as part of the guarantee obligation (see "CONSOLIDATED BALANCE SHEETS ANALYSIS — Guarantee Obligation For Participation Certificates," for additional information about guarantee obligations). As of December 31, 2003 and 2002, 19 percent and 46 percent, respectively, of outstanding PCs and Structured Securities had deferred fees accounted for as a deferred liability, which are currently being amortized into management and guarantee income. On January 1, 2003, we implemented FIN 45 and began amortizing the deferred fees related to PC issuances after this date into income as part of Income (expense) on Guarantee obligation for Participation Certificates to the extent that related transfers of such PCs to third parties were not accounted for pursuant to SFAS 125/140. Therefore, the amount of the deferred liability from prior years that remains to be amortized into management and guarantee income has been decreasing.

In 2002, management and guarantee income increased $124 million, or 9 percent, compared to 2001. This increase in guarantee income was driven by a 17 percent increase in average outstanding PCs. The decrease in the total management and guarantee rate between 2002 and 2001 was driven by lower contractual guarantee fee rates, partially offset by accelerated revenue recognition of deferred fees due to high levels of mortgage prepayments.

Table 19 summarizes management and guarantee income and rates for each quarter in 2003 and 2002.

Table 19 — Quarterly Management and Guarantee Income

	1Q 2003		2Q 2003		3Q 2003		4Q 2003	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)							
Contractual management and guarantee fees	$ 314	17.3	$ 311	17.4	$ 296	17.3	$ 309	17.1
Amortization of deferred fees	244	13.5	165	9.3	(61)	(3.5)	60	3.3
Total management and guarantee income	$ 558	30.8	$ 476	26.7	$ 235	13.8	$ 369	20.4

	1Q 2002		2Q 2002		3Q 2002		4Q 2002	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)							
Contractual management and guarantee fees	$ 326	20.3	$ 341	19.9	$ 340	19.2	$ 328	18.3
Amortization of deferred fees	46	2.9	44	2.5	30	1.7	61	3.4
Total management and guarantee income	$ 372	23.2	$ 385	22.4	$ 370	20.9	$ 389	21.7

As described above, the total management and guarantee rate represents the contractual management and guarantee fee rate as adjusted for amortization of deferred fees, including credit fees and buy-down fees. The amortization component of management and guarantee income representing the recognition of deferred fees is based on the effective interest method required by SFAS 91, which requires estimating the expected weighted average lives of mortgages with related deferred fees. The use of the effective interest method requires periodic adjustments to the amortization of deferred fees, which can cause significant volatility in quarterly income, as both a current period amortization and a cumulative prior period adjustment are recognized in a given period as the effective constant yield changes over time. This volatility is driven primarily by variances between actual and anticipated prepayments, which affects the internal rate of return applied in determining the effective constant yield.

1Q03 vs. 4Q02

Management and guarantee income increased by $169 million, or 43 percent, to $558 million in the first quarter of 2003 from $389 million in the fourth quarter of 2002. This increase was driven primarily by a significant increase in the portion of management and guarantee income representing the amortization of

deferred fees. The decline in contractual guarantee fees received was primarily attributable to a decrease in the proportion of the portfolio of loans with buy-ups due to the turnover of seasoned loans with higher contractual rates.

The increase in the amortization of deferred fees recognized was driven primarily by a decrease in the expected weighted average lives of mortgages underlying our PCs, including the impact of the previously described improvements made to our methodology for estimating the expected weighted average lives of mortgages. These improvements in the quality of our expected weighted average mortgage life estimates resulted in a $110 million dollar increase in management and guarantee income in the first quarter of 2003.

2Q03 vs. 1Q03

Management and guarantee income decreased by $82 million, or 15 percent, to $476 million in the second quarter of 2003 from $558 million in the first quarter of 2003. This decrease primarily reflects the effect of the $110 million adjustment made in the first quarter of 2003 as discussed above. The change in the cash flow portion of management and guarantee income was relatively small, reflective of the two percent decrease in average outstanding PCs.

3Q03 vs. 2Q03

Management and guarantee income decreased by $241 million, or 51 percent, to $235 million in the third quarter of 2003 from $476 million in the second quarter of 2003. This was driven primarily by the fact that amortization expenses were recorded due to the interest rate environment. The change in the contractual guarantee fee portion of management and guarantee income was relatively small, reflective of the four percent decrease in average outstanding PCs.

The change in amortization recognition was driven by an approximately 70 basis point increase in the average 30-year mortgage rate during the quarter, which was greater than previously expected. The resulting increase in the level yield necessary to apply the effective interest method caused us to recognize net amortization expense instead of income in the third quarter of 2003.

4Q03 vs. 3Q03

Management and guarantee income increased by $134 million, or 57 percent, to $369 million in the fourth quarter of 2003 from $235 million in the third quarter of 2003. This increase was driven primarily by an increase in the portion of management and guarantee income representing the amortization of deferred fees. The change in amortization recognition was driven by a return to income amortization after the downward adjustment made to amortization in the third quarter, together with a decrease in the expected weighted average lives of mortgages underlying our PCs. The change in the contractual guarantee fee portion of management and guarantee income reflected the six percent increase in average outstanding PCs.

In 2002, quarterly changes in management and guarantee income and rates were primarily driven by declining contractual management and guarantee fee rates and fluctuations in the rate of revenue recognition due to the amortization of deferred fees. During 2002, mortgage interest rates fluctuated and mortgage prepayments and prepayment expectations increased significantly in periods of falling rates. Declining mortgage rates drove high mortgage prepayment levels and resulted in accelerated recognition of deferred fees. The accelerated amortization of deferred fees was offset by the declining contractual guarantee fee component of management and guarantee fee rates on new business.

Gains (Losses) on Guarantee Asset

Gains (losses) on Guarantee asset for Participation Certificates, at fair value represents the change in fair value of the guarantee asset.

The change in fair value of the guarantee asset reflects:

- The portion of cash received that is considered return of our recorded investment in the guarantee asset; and
- Changes in the fair value of expected future cash inflows.

Factors Affecting the Fair Value of the Guarantee Asset. With the passage of time, actual cash flows are realized and no longer included in the valuation of the guarantee asset. Cash flows received, which are recorded in management and guarantee income, represent a reduction of our investment in the guarantee asset. As depicted in Table 20, cash flows received on the guarantee asset are allocated between interest income (imputed income on the asset based on the discount rate used in the calculation of the fair value of the guarantee asset) and return of investment (the portion of actual cash flows that represents a reduction of the guarantee asset receivable). The realization of cash flows results in a corresponding change in the valuation of the guarantee asset.

The gain or loss due to changes in the value of future expected cash flows is the second component of the change in the fair value of the guarantee asset. The value of expected cash flows is driven by the estimated lives of the mortgages underlying the outstanding PCs and other economic factors that influence the amount and timing of the future cash flows, such as changes in expected interest rates. Changes in the estimated lives of the underlying mortgages affect the value of the guarantee asset because our right to receive guarantee fees ceases when the underlying mortgages prepay.

The portion of the gains and losses on the guarantee asset attributable to these two factors is shown in Table 20 below. See "Table 29 — Changes in Guarantee Asset Balances" in "CONSOLIDATED BALANCE SHEETS ANALYSIS — Guarantee Asset for Participation Certificates" for additional information about the guarantee asset.

Table 20 — Attribution of Change in Fair Value — Guarantee Asset

	2003	2002	2001
	(dollars in millions)		
Total cash flows received	$ (888)	$ (820)	$(803)
Portion of cash flows received related to imputed interest	244	259	273
Return of investment in guarantee assets	(644)	(561)	(530)
Change in fair value of future cash flows	(817)	(1,615)	(259)
Gains (losses) on guarantee asset	$(1,461)	$(2,176)	$(789)

Losses on the guarantee asset decreased $715 million, or 33 percent, to ($1,461) million in 2003 compared to ($2,176) million in 2002 primarily due to a smaller overall decline in mortgage interest rates which tends to directly affect actual and expected prepayments. Declining mortgage interest rates in 2002 and the first half of 2003 reduced the expected lives of the mortgages underlying outstanding PCs and the amount of estimated future guarantee fee cash flows.

Losses on guarantee assets increased to ($2,176) million in 2002 from ($789) million in 2001 mainly due to decreases in mortgage interest rates during 2002, which reduced the expected lives of the mortgages underlying outstanding PCs and the amount of estimated future guarantee fee cash flows.

Table 21 summarizes the 2003 and 2002 quarterly gains and losses on the guarantee asset.

Table 21 — Quarterly Gains (Losses) on Guarantee Asset

	1Q 2003	2Q 2003	3Q 2003	4Q 2003
	(dollars in millions)			
Gains (losses) on guarantee asset	$(568)	$(1,092)	$258	$(59)

	1Q 2002	2Q 2002	3Q 2002	4Q 2002
	(dollars in millions)			
Gains (losses) on guarantee asset	$(213)	$(658)	$(890)	$(415)

In 2003 and 2002, quarterly fluctuations in gains and losses on the guarantee asset were primarily attributable to changes in the expected lives of the mortgages underlying outstanding PCs, which were driven by changes in mortgage interest rates and expected prepayments.

Our guarantee asset primarily relates to our single-family portfolio. Through the first two quarters of 2003, our average single-family portfolio mortgage coupon rate was significantly higher than the prevailing average 30-year mortgage rate, increasing our expectation of prepayments and reducing the value of our guarantee asset. In the third quarter of 2003, mortgage interest rates increased, slowing the pace of liquidations and increasing the fair value of the guarantee asset. Mortgage interest rates dropped slightly during the fourth quarter of 2003, which caused a small decline in the fair value of the guarantee asset. Mortgage interest rates dropped steadily throughout 2002 resulting in a reduction in the fair value of the guarantee asset in each quarter.

Income (Expense) on Guarantee Obligation

With the adoption of FIN 45 on January 1, 2003, we changed the way we account for Income (expense) on Guarantee obligation for Participation Certificates. For 2003, Income (expense) on Guarantee obligation for Participation Certificates represents a reduction of the guarantee obligation based on amortization using the actual prepayment experience on the underlying mortgage loans, which we refer to as the Declining Unpaid Principal Balance Method.

For 2002 and 2001, gains and losses on guarantee obligation represented the change in fair value of the obligation due to:

- *The portion of guarantee-related cash payments made that cause a reduction of the guarantee obligation; and*
- *Changes in the fair value of expected future cash outflows.*

Income (expense) on guarantee obligation was $925 million, $592 million and $203 million in 2003, 2002 and 2001, respectively.

For all years presented in Table 22 below, we established the guarantee obligations at their fair value, which are determined by estimating the amount and timing of cash flows related to the guarantee obligation. Factors in determining the fair value of the guarantee obligation include house price appreciation, interest rates, loan prepayment rates and other economic factors that influence expected credit losses and expected income earned on mortgage principal and interest payments held in our cash and investments portfolio pending remittance to PC investors.

Table 22 summarizes the attribution of change to the guarantee obligation for 2003, 2002 and 2001. See "Table 30 — Changes in Guarantee Obligation Balances" in "CONSOLIDATED BALANCE SHEETS ANALYSIS — Guarantee Obligation for Participation Certificates" for additional information about the guarantee obligation.

Table 22 — Attribution of Change — Guarantee Obligation

	2003[1] Amortization	2002 Fair Value	2001 Fair Value
		(dollars in millions)	
Total cash flows paid	$ —	$422	$278
Portion of cash flows paid related to imputed interest	—	(64)	(57)
Cash paid representing reduction of guarantee obligations	—	358	221
Changes in fair value of future cash flows	—	234	(18)
Amortization	925	—	—
Income (expense) on guarantee obligation	$925	$592	$203

(1) As a result of the implementation of FIN 45 on January 1, 2003, we changed the method of recognizing income (expense) on guarantee obligation.

In 2003, an increase in the balance of guarantee obligation, combined with a 63 percent liquidation rate on outstanding PCs and Structured Securities, resulted in $925 million of income recognized on the amortization of our guarantee obligation.

Income on the guarantee obligation increased in 2002 compared with 2001 due to a number of factors affecting changes in the fair value of the guarantee obligation from period to period. The primary factor in the change in value during 2002 was the gains on the credit-related components of the guarantee obligation, partially offset by losses on the remittance cycle components of the guarantee obligation. Gains on the credit-related components of the guarantee obligation were driven by the general credit environment as well as changes in mortgage rates, which reduced the expected lives of the mortgages underlying outstanding PCs. Losses on the remittance cycle components of the guarantee obligation were driven by higher prepayment estimates combined with lower short-term interest rates, which lowered the expected reinvestment yield and thereby increased the expected net expense associated with amounts due to PC investors.

Table 23 summarizes the 2003 and 2002 quarterly income (expense) on guarantee obligation.

Table 23 — Quarterly Income (Expense) on Guarantee Obligation

	1Q 2003	2Q 2003	3Q 2003	4Q 2003
	(dollars in millions)			
Income (expense) on guarantee obligation	$235	$265	$301	$124
	1Q 2002	**2Q 2002**	**3Q 2002**	**4Q 2002**
	(dollars in millions)			
Income (expense) on guarantee obligation	$146	$156	$62	$228

During the first three quarters of 2003, the income on guarantee obligations increased as a result of two factors:

- The balance of our guarantee obligation increased throughout 2003, driven by the issuance of PCs through the Guarantor and MultiLender Programs during the year, and
- High liquidation rates for outstanding PCs reduced the unpaid principal balances of the PCs, increasing the amortization of the liability into income under the declining unpaid principal balance method.

The liquidation rate of outstanding PCs declined in the fourth quarter of 2003 due to generally higher rates during the second half of the year. As a result, the unpaid principal balances of PCs did not decline as quickly as earlier in 2003, reducing the rate of amortization and the amount of income we recognized.

In 2002, changes in gains and losses on the guarantee obligation reported on a quarterly basis were primarily attributable to changes in the expected lives of the mortgages underlying outstanding PCs, which were driven by changes in mortgage interest rates. Fluctuations in the guarantee obligation were also driven by changes in short-term interest rates and in the credit environment, which also affect the value of future estimated cash flows.

Derivative Gains (Losses)

Derivative gains (losses) represent the change in fair value of derivatives not accounted for in a hedge accounting relationship because the derivatives did not qualify for, or we did not elect to pursue, hedge accounting, resulting in fair value changes being recorded to earnings. Although derivatives are an important aspect of our management of interest-rate risk, they may increase the volatility of reported net income, particularly when they are not accounted for in hedge accounting relationships.

We generally use interest-rate swaps to mitigate contractual funding mismatches between our assets and liabilities. A receive-fixed swap results in our receipt of a fixed interest-rate payment from our counterparty in exchange for a variable rate payment to the counterparty. Conversely, a pay-fixed swap requires us to make a fixed interest-rate payment in exchange for a variable rate payment. Call and put swaptions are options to enter into receive- and pay-fixed interest-rate swaps, respectively. We use swaptions and other option-based derivatives to adjust the contractual funding of our debt in response to changes in the expected lives of assets in the Retained portfolio. Mortgage borrowers generally have an option to prepay their mortgages prior to contractual maturity, and this prepayment option is sensitive to changes in interest rates.

Interest-rate swaps and swaptions that are not accounted for in hedge accounting relationships generally increase the volatility of reported net income since they are marked to fair value through earnings without the offsetting change in value of the economically hedged risk also being recognized in earnings. The fair value of receive- and pay-fixed interest-rate swaps is primarily driven by changes in interest rates, with receive-fixed swaps increasing in value and pay-fixed swaps decreasing in value when interest rates decrease (and the opposite being true when interest rates increase). The fair value of purchased call and put swaptions is sensitive to changes in interest rates in a directionally similar manner to receive- and pay-fixed swaps, respectively. Swaption values are also driven by the market's expectation of potential changes in interest rates in the future (referred to as "implied volatility"), with swaptions generally being more valuable as implied volatility increases and less valuable as implied volatility decreases. Losses on purchased options are limited to the premium paid to purchase the option plus any unrealized gains previously recorded.

Derivative gains (losses) totaled $39 million, $5,302 million and ($2,313) million in 2003, 2002 and 2001, respectively. These gains and losses were primarily driven by changes in the fair value of certain interest-rate swaps and swaptions executed to manage interest-rate risk related to our Retained portfolio as well as commitments to purchase or sell mortgages and mortgage-related securities. The decline in interest rates during the first half of 2003 followed by increases in the third and fourth quarters led to significant quarterly volatility. Net derivative gains of $39 million were generated in 2003, as gains of $2.8 billion on pay-fixed interest-rate swaps were offset by losses of ($0.6) billion on call swaptions, losses of ($0.3) billion on put swaptions, losses of ($0.2) billion on receive-fixed swaps, ($1.0) billion of costs related to periodic interest-rate swap settlements, and ($0.7) billion of losses primarily attributed to commitments to purchase or sell mortgages and mortgage-related securities.

Derivative gains increased from 2001 to 2002 as interest rates declined and increased option volatility led to significant gains on our receive-fixed swaps and call swaptions, which were partially offset by losses on pay-fixed swaps and put swaptions. The notional amounts and related gains and losses for our derivatives not accounted for in a hedge accounting relationship are described in Table 24 below.

Table 24 provides a quarterly summary of the period-end notional amounts and gains and losses related to swaps and swaptions used to manage interest-rate risk but not accounted for in hedge accounting relationships.

Table 24 — Derivatives Not in Hedge Accounting Relationships

	1Q 2003		2Q 2003		3Q 2003		4Q 2003		2003
	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Gain (Loss)
	(dollars in billions)								
Call swaptions	$153.4	$0.3	$167.8	$ 3.1	$173.8	$(3.1)	$216.9	$(0.9)	$(0.6)
Put swaptions	134.5	(0.3)	155.6	(0.3)	146.3	0.3	123.1	—	(0.3)
Receive-fixed swaps	52.7	0.2	24.2	0.6	31.6	(0.5)	13.9	(0.5)	(0.2)
Pay-fixed swaps	28.9	0.2	60.5	(0.4)	57.8	2.1	47.1	0.9	2.8
Subtotal		0.4		3.0		(1.2)		(0.5)	1.7
Accrual of periodic settlements		(0.1)		(0.2)		(0.4)		(0.3)	(1.0)
Other[1]		0.6		0.7		(1.5)		(0.5)	(0.7)
Total		$0.9		$ 3.5		$(3.1)		$(1.3)	$ —

	1Q 2002		2Q 2002		3Q 2002		4Q 2002		2002
	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Gain (Loss)
	(dollars in billions)								
Call swaptions	$106.6	$(1.0)	$129.0	$ 1.7	$120.9	$5.3	$131.4	$(0.6)	$5.4
Put swaptions	91.4	(0.2)	88.4	(1.3)	73.3	(0.5)	129.9	(0.6)	(2.6)
Receive-fixed swaps	82.3	(0.4)	54.2	2.0	70.2	4.1	65.4	(0.1)	5.6
Pay-fixed swaps	63.4	0.9	49.2	(1.9)	55.3	(2.8)	43.4	0.3	(3.5)
Subtotal		(0.7)		0.5		6.1		(1.0)	4.9
Accrual of periodic settlements		(0.2)		(0.3)		(0.2)		(0.1)	(0.8)
Other[1]		(0.2)		0.4		0.4		0.6	1.2
Total		$(1.1)		$ 0.6		$6.3		$(0.5)	$5.3

(1) Other consists of basis swaps, option-based contracts, futures, foreign-currency swaps, commitments, and other derivatives not accounted for in hedge accounting relationships, including a prepayment management agreement and credit derivatives.

Derivative gains (losses) fluctuated significantly during 2003 due to the decrease in interest rates during the first half of 2003 versus an increase in interest rates during the third quarter of 2003. During the second quarter of 2003, derivative gains of $3.5 billion were primarily driven by a $3.1 billion gain in the value of call swaptions, which was due to interest rate declines during the quarter. As interest rates increased during the third quarter of 2003, our call swaptions declined in value by ($3.1) billion and we incurred ($1.4) billion of losses on commitments to purchase or sell mortgages and mortgage-related securities. These losses were partially offset by $2.1 billion in gains on pay-fixed swaps. During 2002, derivative gains (losses) were largest in the third quarter when the gains totaled $6.3 billion. This third quarter gain in 2002 was driven by a $4.8 billion gain on call swaptions, net of losses on put swaptions and a $1.3 billion gain on receive-fixed swaps, net of losses on pay-fixed swaps. The decrease in interest rates in the third quarter of 2002 increased the fair value of the interest-rate swaps underlying the call swaptions, which combined with the increase in the implied volatility of interest rates, resulted in a significant increase in the value of the call swaptions. While increases in implied volatility also have a favorable effect on the value of put swaptions, the decrease in fair value of the underlying pay-fixed interest-rate swaps due to the decrease in interest rates resulted in a net decrease in the fair value of these swaptions during 2002.

Hedge Accounting Gains (Losses)

For those derivatives that are accounted for in a hedge accounting relationship, hedge accounting ineffectiveness generally arises when the fair value change of a derivative financial instrument does not exactly offset the fair value change of the hedged item. Our hedge accounting relationships primarily consist of derivatives linked to either existing debt in a fair value hedge accounting relationship or the variability of interest payments on the forecasted issuances of debt securities in a cash flow hedge accounting relationship.

Hedge accounting gains were $644 million in 2003, compared to hedge accounting gains of $187 million in 2002 and hedge accounting losses of ($294) million in 2001. Hedge ineffectiveness in these years related primarily to our fair value hedge accounting relationships. Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge accounting relationships and the extent to which differences in the characteristics or terms of the derivative and the hedged item result in fair value or cash flow changes that are not exactly offset. For example, a significant portion of derivatives in our fair value hedges are forward starting and valued using forward rates while the hedged debt is valued using spot rates. Therefore, the difference between the spot rate and the forward rate generally produces ineffectiveness in these fair value hedges, which is recognized in this caption.

Gains (Losses) on Investment Activity

Gains (losses) on investment activity include gains and losses on certain assets and liabilities marked to fair value through earnings. Also included are gains and losses related to sales, impairments and other valuation adjustments.

Table 25 summarizes the components of Gains (losses) on investment activity.

Table 25 — Gains (Losses) on Investment Activity

	2003	2002	2001
	(dollars in millions)		
Gains (losses) on trading securities	$(2,130)	$ 921	$ 144
Gains (losses) on PC residuals	(144)	(438)	(121)
Gains (losses) on sale of mortgage loans and available-for-sale securities	2,075	1,958	619
Security impairments[1]	(736)	(650)	(350)
Mortgage lower of cost or market value adjustments	(179)	8	(101)
Total gains (losses) on investment activity	$(1,114)	$1,799	$ 191

(1) Includes impairments on securities classified as available for sale and trading.

Gains (Losses) on Trading Securities were ($2,130) million, $921 million and $144 million in 2003, 2002 and 2001, respectively. Gains (losses) on securities we hold that are classified for accounting purposes as trading represent changes in the fair value of our trading positions, which include trading securities held, certain forward commitments to purchase or sell trading securities, and Treasury and agency debt security "short sale" transactions (also referred to as "securities sold, not yet purchased") executed for asset/liability management purposes. The trading positions consist of securities transactions executed in connection with our PC and mortgage-related security market-making and support activities and certain securities held in the Retained portfolio and in the cash and investments portfolio.

Entering 2003, our trading portfolio contained higher coupon mortgage-related securities that were in an unrealized gain position. The portfolio experienced losses because these higher coupon mortgage-related securities experienced significant prepayments during the first half of 2003 as interest rates fell. The interest earned on trading assets in the same period is included in net interest income. In addition, during the third and fourth quarters of 2003 the portfolio experienced losses as rising interest rates decreased the value of investments.

In 2002 trading gains were positively affected by the decline in interest rates during the year. In 2001, trading gains were negatively affected as we transferred approximately $36 billion of securities to the trading

category on January 1, 2001, in conjunction with the implementation of SFAS 133 resulting in an unrealized loss of approximately $275 million being recorded to earnings.

Gains (Losses) on PC Residuals were ($144) million, ($438) million and ($121) million in 2003, 2002 and 2001, respectively. PC residuals relate to certain PCs and Structured Securities we hold and represent the fair value of the future cash flows of guarantee contracts that specifically correspond to such PCs or Structured Securities. PC residuals that are classified as trading securities are marked to fair value as a component of Gains (losses) on investment activity. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for more information on PC residuals.

Net cash payments we receive on PC residuals are reported in the consolidated statements of income (primarily within net interest income as well as through components of non-interest expense that are credit and administrative related) and not as a direct reduction of the recorded PC residual. In 2003, losses on PC residuals decreased compared with 2002 due to a smaller overall decline in mortgage interest rates experienced during the year. In addition, the proportion of PCs and Structured Securities held by us that had a recognized PC residual associated with them increased to 72 percent in 2003 from 38 percent in 2002 due to the adoption of FIN 45 together with an increase in the amount of Retained portfolio purchase activity. Realization of cash flows and decreases in interest rates, which reduced the expected lives of the associated securities, accounted for the reported loss in 2002. In 2001, the loss was primarily due to the realization of cash flows.

Gains (Losses) on Sale of Mortgage Loans and Available-for-Sale Securities were $2,075 million, $1,958 million and $619 million in 2003, 2002 and 2001, respectively. The increasing gains on the sale of mortgage loans and available-for-sale securities for 2003, 2002 and 2001 were primarily attributable to the increasing volume of sales of PCs and Structured Securities in all years, as well as the sales of Treasury and agency debt securities, originally purchased for asset/liability management purposes during 2003. In 2003, the increase in gains was also driven by an increase in the volume of transfers of PCs and Structured Securities that qualified as sales under SFAS 125/140, thereby triggering gains or losses based on differences in newly recognized guarantee assets and guarantee obligations.

Security Impairments were ($736) million, ($650) million and ($350) million in 2003, 2002 and 2001, respectively. We record impairment losses on our investment portfolio when we have concluded that a decrease in the fair value of a security is other than temporary. Impairment losses recognized in 2003, 2002 and 2001 were primarily related to certain investments in mortgage-related interest-only securities and manufactured housing securities.

The primary source of impairment losses for the years presented was related to mortgage-related interest-only securities. Impairment losses on mortgage-related interest-only securities totaled ($524) million, ($568) million and ($325) million in 2003, 2002 and 2001, respectively. EITF 99-20 was implemented in the second quarter of 2001 when it became effective. EITF 99-20 requires the cost basis of a mortgage-related interest-only security to be written down to fair value when there is both a decline in fair value below the carrying amount and an adverse change in expected cash flows. See "CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLES, NET OF TAXES" below for more information on the cumulative effect to net income from the adoption of EITF 99-20.

Decreasing interest rates result in a decrease in expected cash flows from mortgage-related interest-only securities and a corresponding decrease in the fair value of these securities. During the first half of 2003, interest rates continued to decline from 2002 levels resulting in an increase in prepayments and, in turn, a higher level of impairment losses than in the prior year. In 2003, interest rates decreased sharply during the first and second quarters; as a result, 86 percent of the 2003 mortgage-related interest-only securities impairment losses were recognized in those quarters. As interest rates began to rise in the third and fourth quarters of 2003, impairment losses recognized were greatly reduced. The increase in mortgage-related interest-only security impairment losses during 2002 relates to the decline in interest rates as compared to 2001.

SFAS No. 115 "Accounting for Certain Investments in Debt and Equity Securities," or SFAS 115, is the primary accounting standard applied in determining impairments of non-interest-only securities. Impairments recorded on non-interest-only securities totaled ($212) million, ($82) million and ($25) million in 2003, 2002

and 2001, respectively, with impairments on manufactured housing securities totaling ($208) million, ($67) million and ($23) million during the same periods. See "LIQUIDITY AND CAPITAL RESOURCES — Liquidity — *Cash and Investments Portfolio*" for more information about our non-mortgage-related securities. We recognize an impairment if the decrease in fair value of a security below its carrying value is determined to be other than temporary. More specifically, we recognize an impairment when a security fails one or more of a series of objective criteria relative to its fair value compared to its amortized cost, credit ratings or the amount of time the investment has been in an unrealized loss position, or if we otherwise believe that an unrealized loss is other than temporary based on qualitative indicators of potential impairment. Impairment losses on manufactured housing securities exclude the effects of separate financial guarantee contracts that are not embedded in the securities since the benefits of such contracts are not recognized until claims become probable of recovery under the contracts.

Mortgage lower of cost or market value Adjustments were ($179) million, $8 million and ($101) million in 2003, 2002 and 2001, respectively. We record mortgage loans classified as held-for-sale in accordance with SFAS No. 65, "Accounting for Certain Mortgage Banking Activities," or SFAS 65, at the lower of amortized cost or market value, or lower of cost or market value, with changes in the valuation of our held-for-sale portfolio recorded to this caption.

Losses related to loans held in the Retained portfolio as held-for-sale are recorded as a reduction to the cost basis in the Retained portfolio assets and are amortized into income over the estimated life of the assets as part of Net interest income.

Mortgage lower of cost or market value losses were primarily recognized in the third quarter of 2003, totaling ($178) million. The sharp decline in mortgage interest rates in the second quarter of 2003 resulted in an increase in mortgages purchased as the market experienced heavy refinancing activity. A sharp increase in mortgage interest rates during the third quarter of 2003 reduced the value of our held-for-sale mortgage loan portfolio resulting in lower of cost or market value adjustments.

Gains (Losses) on Debt Retirement

We record gains and losses on debt repurchases that are accounted for as extinguishments of debt based on the difference between the contractual interest rates on the debt securities repurchased (adjusted for deferred premiums, discounts, and hedging gains and losses) and current market interest rates, and the write-off of related deferred debt issuance costs. To the extent we issue new debt securities to replace the debt that we retire, the difference in the debt costs will positively or negatively affect net interest income to be reported in future periods.

We incurred pre-tax losses of ($1,775) million, ($674) million and ($356) million on the repurchase of approximately $27 billion, $20 billion and $5 billion in principal amount of debt outstanding in 2003, 2002 and 2001, respectively. The most significant debt repurchases in 2003 occurred in the second quarter when we repurchased an aggregate of approximately $17 billion of U.S. dollar and Euro-denominated debt securities, most of which followed the announcement of changes in our senior management. We executed these particular repurchases in an effort to support the liquidity and price performance of these securities. Of the ($1,775) million of pre-tax losses incurred in 2003, ($1,266) million was incurred in the second quarter. Where we have designated derivatives as accounting hedges of issued debt securities, we recognize any deferred hedging gains or losses upon the retirement of that debt.

Resecuritization Fees

Resecuritization fees are revenues we earn primarily in connection with the issuance of Structured Securities with underlying collateral provided by third parties for which we made a REMIC election. These fees are also generated in connection with the creation of interest-only and principal-only strips as well as other Structured Securities.

Resecuritization fees totaled $352 million, $276 million and $135 million in 2003, 2002 and 2001, respectively. Investors' demand for Structured Securities increased significantly in all three years largely due to the steepening of the yield curve during these periods. A steep yield curve generally increases the value of

structured cash flows, which results in greater value differences between PCs and Structured Securities as well as a corresponding increase in the volume of new Structured Securities being issued.

Other Income and Certain Prior Year Accounting Error Adjustments

Other income primarily consists of fees associated with servicing and technology-related programs, including Loan Prospector®, various fees related to multifamily loans (including application and other fees) and various other fees received from mortgage originators and servicers. In 2003, other income also includes the correction of certain immaterial prior year accounting errors.

Other income totaled $493 million, $321 million and $229 million in 2003, 2002 and 2001, respectively. In the process of reviewing our accounting policies and practices for 2003, we identified certain immaterial errors that resulted in the cumulative net understatement of income of approximately $214 million ($139 million after-tax). An adjustment to correct this understatement was recorded in the first quarter of 2003. This adjustment includes approximately $271 million of income recorded to correct the accounting for certain swaption transactions that were physically settled (*i.e.*, by actually entering into the underlying swap) during 2002, but for which the value of the underlying swap on the settlement date was not correctly recorded, and approximately $27 million of income related to the recognition of loan prepayment fees earned in 2002, but recorded in 2003. These corrections were partially offset by a ($26) million reduction of income to correct for errors in the calculation of the change in fair value of the hedged risk within certain hedges of foreign denominated debt and a ($58) million reduction in income to correct the equity-method earnings that were recorded on certain low income housing tax credit partnerships based on the use of tax-basis financial statements when GAAP-basis financial statements were available. The increase in this category during 2002 is primarily due to an increase in servicing and transaction fees resulting from increased business volumes and use of our automated underwriting tools by third parties.

Non-Interest Expense

Credit-Related Expenses

Credit-related expenses include the Provision for credit losses and REO operations income (expense). The Provision for credit losses includes provisions for losses incurred on (1) mortgage loans held in the Retained portfolio that are held for investment, (2) outstanding PCs, and (3) that portion of Structured Securities held by third parties that are backed by non-agency mortgage-related securities. REO operations income (expense) includes certain costs associated with the acquisition of real estate at the time of foreclosure, gains and losses on the sale of foreclosed properties we hold, as well as the cost to hold these properties, including real estate taxes, insurance, repairs and fees incurred to prepare the properties for sale, and provision for valuation losses occurring between acquisition and disposition.

Table 26 summarizes the components of credit-related expenses (expenses are presented as bracketed amounts in this table).

Table 26 — Credit-Related Expenses

	2003	2002	2001
	(dollars in millions)		
Provision for credit losses	$(10)	$(128)	$(32)
REO operations income (expense)	23	13	(7)
Total credit-related income (expenses)	$ 13	$(115)	$(39)

The Provision for credit losses may be expense or income, depending on whether the loan loss reserve balances need to be increased or decreased at the end of any given period. Total credit-related expenses decreased by $128 million in 2003, compared to an increase of $76 million in 2002. The Provision for credit losses was ($10) million for 2003, compared to ($128) million for 2002 and ($32) million for 2001. We establish the credit loss reserve based on our periodic assessment of estimated incurred losses. The Provision for credit losses was lower in 2003 than 2002 primarily due to the 2002 provision reflecting an increase in expected losses on multifamily mortgage loans, driven by higher vacancy rates and a decrease in net operating

income of multifamily properties in certain markets. In addition, in 2003, our single-family loan portfolio continued to benefit from loss mitigation strategies, strong house price appreciation and recoveries.

The increase in total credit-related expenses in 2002 as compared to 2001 primarily reflects an increase in estimated incurred losses on multifamily mortgage loans due to higher vacancy rates and a decrease in net operating income of multifamily properties in certain areas. The increase in 2002 in Provision for credit losses was partially offset by an increase in income from operations related to real estate owned, or REO.

Administrative Expenses and Other Expenses

Salaries and employee benefits, professional services, occupancy expense and certain other expenses, including those related to our remediation efforts, are collectively referred to as administrative expenses. These costs are generally incurred to conduct daily operations although in certain cases, costs related to charitable contributions and other specific transactions or events are included in this category.

Table 27 summarizes administrative and other expenses (expenses are presented as bracketed amounts in this table).

Table 27 — Administrative Expenses and Other Expenses

	2003	2002	2001
	(dollars in millions)		
Salaries and employee benefits	$ (624)	$ (593)	$ (537)
Occupancy expense	(52)	(42)	(35)
Other expenses — administrative (including professional services)	(578)	(373)	(344)
Total administrative expenses	(1,254)	(1,008)	(916)
Other expenses — non-administrative:			
Amortization of credit enhancements	(134)	—	—
OFHEO civil money penalty	(125)	—	—
Select affordable housing transaction fees	(124)	—	—
Loan Prospector®-related expenses	(99)	(86)	(76)
Loss contingency expense[1]	(75)	—	—
Realized losses on certain guarantees	(60)	—	—
Charitable contributions	(6)	(260)	(32)
Disposition of certain technology-related assets	—	(52)	—
Total administrative and other expenses	$(1,877)	$(1,406)	$(1,024)

(1) See "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements for additional information.

Total administrative and other expenses were ($1,877) million, ($1,406) million and ($1,024) million in 2003, 2002 and 2001, respectively. As shown in Table 27 above, administrative expenses totaled ($1,254) million, ($1,008) million and ($916) million in 2003, 2002 and 2001, respectively. The increase in administrative expenses for 2003 was primarily driven by additional accounting, auditing and consulting costs of approximately ($124) million and legal costs of approximately ($48) million associated with the restatement and remediation activities in 2003. The ($124) million comprises approximately ($56) million of added professional services expenses, ($15) million of added compensation costs and ($53) million of other costs, principally related to increased audit fees. Salaries and benefits also rose in each year as we increased the number of employees and increased salaries.

Expenses were also higher in 2003 as we paid a ($125) million civil money penalty in connection with the OFHEO consent order which was accrued in the second quarter of 2003. Additionally, the second quarter of 2003 included a ($75) million expense for a loss contingency reserve related to legal proceedings arising from the restatement. See "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements for additional information. Also, during the third and fourth quarters of 2003, we entered into certain affordable housing transactions that contained a number of contractual incentives, including the payment of fees totaling ($124) million.

Furthermore, we began recognizing amortization of credit enhancements and realized losses related to certain guarantees in Other expenses in 2003 which totaled ($194) million. As discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements, in 2003, we changed our accounting for credit enhancements, and guarantee assets and guarantee obligations. For 2003, credit enhancements are included in Other assets and amortized into Other expenses over time. In 2002, credit enhancements were included in the carrying value of the guarantee asset and changes in their carrying value were included in Gains (Losses) on guarantee asset for Participation Certificates, at fair value. Pursuant to the requirements of FIN 45, in 2003, we began recording guarantee assets and guarantee obligations at fair value on PCs issued through our Guarantor Program. Any excess of the related guarantee obligation over the guarantee asset and other assets that relate to recognized credit enhancements is immediately recognized as realized losses on certain guarantees.

Total charitable contributions for 2002 were ($260) million, including a special ($225) million cash contribution to the Freddie Mac Foundation and corporate giving programs announced in the fourth quarter. The contribution to the Freddie Mac Foundation is expected to provide operating funds for the Foundation for six to eight years. In 2002, Other expenses also included a ($52) million loss recognized in the fourth quarter of 2002 related to the disposition of certain technology-related assets.

Housing Tax Credit Partnerships

Housing tax credit partnerships represent our share of the net operating losses generated from investments in partnerships that develop or rehabilitate low-income multifamily rental properties. Although these partnerships generate operating losses, we realize a return on our investment through reductions in Income tax expense, which result from tax credits and the deductibility of the operating losses.

Our share of net operating losses generated from our investment in Housing tax credit partnerships totaled ($200) million, ($160) million and ($121) million in 2003, 2002 and 2001, respectively. Also see "Other Income and Certain Prior Year Accounting Error Adjustments," for information concerning adjustments related to Housing tax credit partnerships recorded in Other income during 2003. The year-over-year increases in this expense primarily reflect our increased investment in such partnerships. The related tax benefits, which are reported as a reduction in Income tax expense, totaled $302 million, $220 million and $172 million in 2003, 2002 and 2001, respectively.

Minority Interest in Earnings of Consolidated Subsidiaries

Minority interest in earnings of consolidated subsidiaries represents the earnings due to third party investors in our consolidated subsidiaries.

Minority interest in earnings of consolidated subsidiaries totaled ($157) million, ($184) million and ($208) million in 2003, 2002 and 2001, respectively. The majority of this amount for each of 2003, 2002 and 2001 relates to dividends on the preferred stock issued by our two majority-owned real estate investment trust, or REIT, subsidiaries. These amounts will continue to decrease as the recorded amount of the REITs' preferred stock declines over time. See "NOTE 18: MINORITY INTEREST" to our consolidated financial statements for more information concerning the REITs.

Income Tax Expense

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

Income tax expense was ($2,202) million, ($4,713) million and ($1,339) million in 2003, 2002 and 2001, respectively. The effective tax rates for 2003, 2002 and 2001 were 31.4 percent, 31.8 percent and 30.1 percent, respectively. The decrease in the effective tax rate from 2002 to 2003 was due to lower growth in pre-tax income in relation to tax credits and interest income on tax-exempt securities. These effects were partially

offset by a non-tax deductible ($125) million OFHEO civil money penalty and a ($75) million loss contingency reserve related to legal proceedings arising from the restatement which were recorded in the second quarter of 2003, as well as a decrease to the tax reserve related to favorable U.S. Tax Court rulings recorded in the fourth quarter of 2002. See "NOTE 13: LEGAL CONTINGENCIES" and "NOTE 14: INCOME TAXES" to the consolidated financial statements for more information.

Cumulative Effect of Change in Accounting Principles, Net of Taxes

Cumulative effect of change in accounting principles includes the effects of adopting SFAS 133 on January 1, 2001 and EITF 99-20 on April 1, 2001.

The after-tax adjustments required by SFAS 133 resulted in a $78 million increase in net income for the first quarter of 2001. The cumulative effect on earnings from the change in accounting principle is primarily attributable to an after-tax gain of $52 million resulting from recording certain options at their fair value and an after-tax gain of $26 million due to cumulative accounting ineffectiveness on hedge accounting relationships involving receive-fixed swaps previously accounted for under accrual accounting. The adoption of EITF 99-20 resulted in a $35 million decrease to net income in the second quarter of 2001. This after-tax adjustment was related to impairment losses required under EITF 99-20 on certain interest-only securities held at April 1, 2001.

CONSOLIDATED BALANCE SHEETS ANALYSIS

Table 28 provides summary consolidated balance sheets as of December 31, 2003 and 2002. This table should be viewed in conjunction with the complete consolidated balance sheets.

Table 28 — Summary Consolidated Balance Sheets

	December 31, 2003	December 31, 2002
	(dollars in millions)	
Retained portfolio	$660,357	$589,722
Cash and investments	109,078	135,037
Derivative assets, at fair value	16,180	10,393
Guarantee asset for Participation Certificates, at fair value	3,686	2,445
Other items included in total assets	14,148	14,652
Total assets	$803,449	$752,249
Total debt securities, net	$739,613	$665,696
Due to Participation Certificate investors	13,205	35,080
Guarantee obligation for Participation Certificates	2,904	1,427
Derivative liabilities, at fair value	357	967
Other items included in total liabilities	13,954	15,440
Total liabilities	770,033	718,610
Minority interest in consolidated subsidiaries	1,929	2,309
Total stockholders' equity	31,487	31,330
Total liabilities and stockholders' equity	$803,449	$752,249

During 2003, our total assets grew $51.2 billion, or 7 percent. This increase was driven by increases in the Retained portfolio partially offset by decreases in cash and investments. During the same period, total liabilities, plus minority interest in consolidated subsidiaries, increased by $51.0 billion, which was driven by increases in total debt securities partially offset by decreases in the amount due to PC investors. These and other changes in our consolidated balance sheets are discussed below.

Retained Portfolio

The Retained portfolio includes mortgage loans and mortgage-related securities that we acquire for investment purposes and primarily consists of Freddie Mac and other agency securities.

The carrying value of the Retained portfolio increased by $70.6 billion, or 12 percent, to $660.4 billion in 2003 from $589.7 billion in 2002 with the largest growth occurring in the third quarter of 2003. The Retained portfolio unpaid principal balance (which excludes premiums, discounts, deferred fees and other basis adjustments, the Reserve for losses on mortgages held for investment, unrealized gains or losses on mortgage-related securities and PC residuals) increased 14 percent during 2003. We generally increase our mortgage-related investment activity when market conditions provide investment returns that exceed threshold levels. Such opportunities are more likely to be available when there is less competition for mortgage-related investments from other investors. Interest rates were extremely low through the first half of 2003 resulting in the lowest mortgage rates seen in the last 45 years. These low rates created a large wave of refinancing activity in the mortgage industry, leading to significant liquidations of mortgage-related securities held in the portfolio. Despite these liquidations, there was an increase in mortgage-related security supply due to refinancing activity and new purchase money activity. The increase in supply coupled with opportunities to retain selected cash flows on structured securitizations generated strong portfolio growth, especially in the third quarter as residential real estate closings hit record highs.

Cash and Investments

Cash and investments include investments we acquire to manage recurring cash flows, provide a source of liquidity, temporarily deploy capital until the capital can be redeployed into Retained portfolio investments or credit guarantee business opportunities and manage interest-rate risk exposure. Cash and investments also include certain mortgage-related securities that are not included in the Retained portfolio since they are acquired in conjunction with our PC market-making and support activities, conducted primarily through SS&TG.

The ending balances of our cash and investments portfolio decreased by $26.0 billion, or 19 percent, to $109.1 billion in 2003 from $135.0 billion in 2002 primarily due to the liquidation of Treasury securities held in the portfolio during the first quarter of 2003 after we determined that these transactions did not qualify as derivatives under GAAP. Accordingly, during 2003, we stopped using such securities to manage our interest-rate risk. Additionally, over the course of 2003, we reduced the amount of non-mortgage related asset-backed securities and corporate debt securities we held while increasing our cash and cash equivalents balances.

Derivative Assets and Liabilities, at Fair Value

All derivatives are reported at fair value with changes in the fair value of derivatives accounted for in hedge accounting relationships recorded to AOCI (for the effective portion of cash flow hedge only) and/or Hedge accounting gains (losses). Changes in fair value of derivatives not accounted for in hedge accounting relationships are recorded to Derivative gains (losses). We use derivatives to manage our interest-rate risk exposure. However, hedge accounting has not been applied to many derivative transactions since a significant number of transactions did not meet hedge accounting requirements or we elected not to pursue hedge accounting.

The balance of derivatives in a gain position (reported as Derivative assets, at fair value) increased by $5.8 billion, or 56 percent, to $16.2 billion at December 31, 2003 from $10.4 billion at December 31, 2002, while the balance of derivatives in a loss position (reported as Derivative liabilities, at fair value) decreased by $0.6 billion, or 63 percent, to $0.4 billion at December 31, 2003 from $1.0 billion at December 31, 2002. Derivative assets and liabilities are presented on the consolidated balance sheets at their fair values, which are affected by changes in market conditions such as the level and expected volatility of interest rates. During 2003, pay-fixed swaps and foreign-currency swaps increased in fair value by approximately $9.3 billion and $3.4 billion, respectively, partially offset by a decrease in fair value of receive-fixed swaps of $5.1 billion. The increase in the value of pay-fixed swaps was driven by the increase in interest rates during the latter part of 2003. The increase in the value of foreign-currency swaps was primarily driven by the increase in the Euro exchange rate against the U.S. dollar during 2003.

The composition of the derivatives we hold will change from period to period as a result of derivative purchases, sales and terminations. The carrying value of our derivative assets and liabilities at each consolidated balance sheet date is equal to the fair value of the derivatives we hold on those dates. As noted previously, changes in fair values are either recorded in current income or may be deferred in AOCI or as basis adjustments to the hedged item. As a result, the increases or decreases in fair value by derivative categories (*e.g.*, pay-fixed swaps), described above, will not correspond directly to Derivative gains (losses) or Hedge accounting gains (losses) on our consolidated statements of income.

Guarantee Asset for Participation Certificates

The Guarantee asset for Participation Certificates represents the fair value of future cash inflows related to our guarantee of PCs and Structured Securities transferred to third parties that qualify as sales or that were subject to the requirements of FIN 45.

The guarantee asset balances increased by $1.2 billion, or 51 percent, to $3.7 billion in 2003 from $2.4 billion in 2002. The changes in the guarantee asset balances during 2003 and 2002 are summarized in Table 29.

Table 29 — Changes in Guarantee Asset Balances

	2003	2002
	(dollars in millions)	
Beginning balance	$ 2,445	$ 3,156
Adjustment for change in accounting[1][2]	(128)	—
Additions, net	2,823	1,465
Changes in fair value[2]	(1,454)	(2,176)
Ending balance	$ 3,686	$ 2,445

(1) As of January 1, 2003, the fair value of those credit enhancements that were previously recognized as a component of guarantee assets were reclassified to Other assets.
(2) Subsequent to the announcement of our 2003 financial results in our Information Statement Supplement dated June 30, 2004, we revised the amount of Adjustment for change in accounting and Changes in fair value. The effect of the revision was an increase of $7 million in Adjustment for change in accounting and a decrease of $7 million in Changes in fair value.

The increase in net additions to the guarantee asset balance in 2003 compared to 2002 was primarily due to the adoption of FIN 45. Additions, net now includes the fair value of the guarantee assets related to both new PCs created through the Guarantor Program as well as a portion of those PCs and Structured Securities issued through other similar transactions, and transactions involving PCs and Structured Securities that qualified as sales. The guarantee asset is presented net of reductions attributable to purchases of PCs and Structured Securities. Purchases result in a reduction of the associated guarantee asset and re-establishment of those amounts as PC residuals.

In 2002, additions include the fair value of the guarantee asset related to:

- PCs and Structured Securities sold subject to SFAS 125/140 during the period, net of reductions attributable to purchases of these securities; and

- Buy up payments we make in connection with transactions we execute through our Guarantor Program or other similar mortgage swap transactions.

Total Debt Securities, Net

We issue non-callable and callable short- and long-term debt securities in domestic and global capital markets in a wide range of maturities to meet our funding needs. The balance of debt securities includes deferred premiums, discounts and hedging gains and losses.

Total debt securities increased by $73.9 billion, or 11 percent, to $739.6 billion in 2003 from $665.7 billion in 2002, corresponding to the growth in the Retained portfolio as discussed previously. During 2003, debt due within one year rose by $50.8 billion, while debt due after one year rose by $23.1 billion. As a result of declining interest rates in the first half of 2003, the expected lives of assets held in the Retained portfolio decreased, reducing the need for long-term debt. To shorten the effective weighted average lives of our debt and thereby manage the funding mismatch created by the decline in interest rates, we issued additional short-term debt, extinguished long-term debt by calling and repurchasing debt and further shortened the duration of our debt by terminating pay-fixed swaps and entering into receive-fixed swaps.

Guarantee Obligation for Participation Certificates

The Guarantee obligation for Participation Certificates represents the amortized cost of our obligation to guarantee the payment of principal and interest of PCs and Structured Securities, initially established at fair value in transactions that qualify as sales or were subject to the requirements of FIN 45.

The Guarantee obligation for Participation Certificates increased by $1.5 billion to $2.9 billion in 2003 from $1.4 billion in 2002. The changes in the guarantee obligation balances during 2003 and 2002 are summarized in Table 30.

Table 30 — Changes in Guarantee Obligation Balances

	2003	2002
	(dollars in millions)	
Beginning balance	$1,427	$1,155
Adjustment for change in accounting(1)	(110)	—
Additions, net		
Fair value of newly issued guarantee obligations(2)	1,684	864
Deferred gains on newly executed guarantees(3)	847	—
Amortization of obligations and deferred gains(4)	(925)	—
Transfer-out during the period(5)	(19)	—
Change in fair value	N/A	(592)
Ending balance	$2,904	$1,427

(1) On January 1, 2003, that portion of recognized guarantee obligations that was attributable to estimated incurred losses on outstanding PCs or Structured Securities, of $110 million, was reclassified to Reserve for guarantee losses on Participation Certificates.
(2) Includes the fair value of guarantee obligations that were recognized in connection with transfers of PCs and Structured Securities in 2003 that qualified as sales, as well as the fair value of guarantee obligations recognized in 2003 that related to PCs and Structured Securities that were issued in Guarantor swaps and other similar transactions subject to FIN 45.
(3) Represents the excess of recognized guarantee assets and other assets (that relate to recognized credit enhancements) over recognized guarantee obligations that are deferred as a component of recognized guarantee obligations. Such deferred amounts are adjusted for buy-downs and credit fees received on Guarantor swaps and other similar transactions. Negative differences between such assets and liabilities are immediately recognized in earnings.
(4) Effective January 1, 2003, recognized guarantee obligations were no longer subsequently measured on a fair value basis through earnings. Rather, we began to amortize such liabilities into earnings on a Declining Unpaid Principal Balance Method.
(5) Represents estimated losses that were incurred in 2003 related to PCs and Structured Securities transferred to third parties in 2003.

The increase in the guarantee obligation balance to $2.9 billion in 2003 from $1.4 billion in 2002 was primarily due to the adoption of FIN 45. In 2003, additions to the guarantee obligation balance include the fair value of guarantee obligations established on new PCs created through the Guarantor Program and other similar transactions, as well as transactions involving PCs and Structured Securities that qualified as sales. The guarantee obligation balance also includes the positive excess of recognized guarantee assets and other assets that relate to recognized credit enhancements over recognized guarantee obligations, the excess of which we refer to as Day One Differences.

The guarantee obligations are presented net of reductions attributable to purchases of PCs or Structured Securities. Purchases result in a reduction of the associated guarantee obligations and re-establishment of those amounts at their then fair value as a component of the related PC residuals. The fair value of the Day One Difference is also presented net of reductions attributable to purchases of PCs or Structured Securities. Purchases also result in the extinguishment of the Day One Difference and a corresponding adjustment to the cost basis of purchased PCs or Structured Securities.

The guarantee obligation is also reduced to the extent that, upon initial recognition, a portion of such amounts can be observed to relate to incurred losses on underlying mortgage loans. In this case, that portion of such amounts that relates to incurred losses on securitized mortgage loans is reclassified to Reserve for guarantee losses on Participation Certificates. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for further discussion.

In 2002, additions include the fair value of the obligation related solely to PCs and Structured Securities sold subject to SFAS 125/140 during the period, net of reductions attributable to purchases of PCs or Structured Securities.

Factors contributing to the change in the fair value and amortization of the guarantee asset and guarantee obligation are discussed in "CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss) — *Gains (Losses) on Guarantee Asset"* and "Income (Expense) on Guarantee Obligation."

Due to Participation Certificate Investors

Timing differences between our receipt of principal and interest payments from mortgage servicers and the subsequent pass through to PC investors result in the liability Due to Participation Certificate investors.

Amounts due to PC investors decreased by $21.9 billion, or 62 percent, to $13.2 billion in 2003 from $35.1 billion in 2002. This decrease was due to the increase in interest rates during the second half of 2003, which resulted in decreased mortgage prepayments at year-end 2003 compared to year-end 2002. The liquidation rate on total PCs issued and Structured Securities, including PCs and Structured Securities we hold, declined to 30 percent (annualized) in the fourth quarter of 2003, down significantly from the fourth quarter of 2002.

Total Stockholders' Equity

Total stockholders' equity increased by $0.2 billion to $31.5 billion in 2003 from $31.3 billion in 2002. Table 31 summarizes the components of stockholders' equity.

Table 31 — Total Stockholders' Equity

	2003	2002
	(dollars in millions)	
Preferred stock	$ 4,609	$ 4,609
Common stock	152	152
Additional paid-in capital	814	744
Retained earnings	28,837	24,955
AOCI, net of taxes, related to:		
Available-for-sale securities	6,349	12,217
Cash flow hedge relationships	(7,837)	(9,877)
Minimum pension liability	(10)	—
Treasury stock	(1,427)	(1,470)
Total stockholders' equity	$31,487	$31,330

The primary drivers of the increase in total stockholders' equity for 2003 were an increase in retained earnings and lower deferred losses on cash flow hedge relationships included in AOCI, net of taxes, offset by losses in AOCI, net of taxes, related to Available-for-sale securities. Generally, the fair value of the available-for-sale portfolio would be expected to move inversely to long-term interest rates. However, despite the decline in interest rates during the first and second quarters of 2003, the available-for-sale portfolio declined in value during 2003 because of the high prepayments experienced at the beginning of 2003 when interest rates were lower. The rise in interest rates during the third and fourth quarters of 2003 also contributed to the overall decline in value for 2003.

AVERAGE CONSOLIDATED BALANCE SHEETS AND RATE/VOLUME ANALYSIS

Table 32 reflects an analysis of net interest income and presents average balances and related yields earned on assets and rates paid on liabilities. Average balance sheet information is presented because we believe end-of-period balances may not always be representative of activity throughout the periods presented. We also believe that the rate/volume analysis may be helpful in understanding how changes in business volumes and yields influenced our financial results, particularly net interest income on earning assets. For most components of the average balances, a daily weighted average balance is calculated for the period. When daily weighted average balance information is not available, a simple monthly average balance is calculated. In addition, Net interest income/yield (fully taxable equivalent basis) is presented on this table. Taxable equivalent adjustments to interest income involve the conversion of tax-exempt sources of interest income to the equivalent amounts of interest income that would be necessary to derive the same net return if the investments had been subject to income taxes using our statutory tax rate (35 percent).

Table 32 — Average Consolidated Balance Sheets and Rate/Volume Analysis

	Year Ended December 31,								
	2003			2002			2001		
	Average Balance[1][2]	Interest Income/ Expense	Average Rate[4][5]	Average Balance[1][2][3]	Interest Income/ Expense	Average Rate[4][5]	Average Balance[1][2]	Interest Income/ Expense	Average Rate[4][5]
	(dollars in millions)								
Interest-earning assets:									
Mortgage loans[6]	$ 63,396	$ 4,251	6.70%	$ 61,077	$ 4,290	7.02%	$ 60,751	$ 4,385	7.22%
Mortgage-related securities in the Retained portfolio[7][8]	544,396	29,051	5.34	470,450	30,039	6.39	387,839	26,847	6.92
Total Retained portfolio	607,792	33,302	5.48	531,527	34,329	6.46	448,590	31,232	6.96
Investments[9]	94,768	3,246	3.40	91,794	3,693	3.99	63,952	3,419	5.30
Securities purchased under agreements to resell and Federal funds sold	49,085	550	1.12	29,032	454	1.56	21,270	717	3.37
Total interest-earning assets	$751,645	$ 37,098	4.93	$652,353	$ 38,476	5.89	$533,812	$ 35,368	6.62
Interest-bearing liabilities:									
Short-term debt	$226,850	$ (2,785)	(1.21)	$209,551	$ (4,303)	(2.03)	$211,493	$ (9,056)	(4.23)
Long-term debt[10]	478,028	(22,083)	(4.62)	406,802	(21,337)	(5.24)	291,489	(17,494)	(6.00)
Total debt securities	704,878	(24,868)	(3.52)	616,353	(25,640)	(4.15)	502,982	(26,550)	(5.25)
Due to Participation Certificate investors	26,234	(1,641)	(6.26)	18,110	(1,236)	(6.82)	14,136	(1,027)	(7.27)
Total interest-bearing liabilities	731,112	(26,509)	(3.62)	634,463	(26,876)	(4.23)	517,118	(27,577)	(5.31)
Income (expense) related to derivatives[10][11][12]		(1,091)	(0.15)		(2,075)	(0.32)		(343)	(0.07)
Impact of net non-interest bearing funding	20,533		0.10	17,890	—	0.13	16,694	—	0.17
Total funding of interest-earning assets	$751,645	$(27,600)	(3.67)	$652,353	$(28,951)	(4.43)	$533,812	$(27,920)	(5.21)
Net interest income/yield[12]		$ 9,498	1.27		$ 9,525	1.46		$ 7,448	1.41
Fully taxable equivalent adjustment[13]		227	0.03		252	0.04		237	0.04
Net interest income/yield (fully taxable equivalent basis)[12]		$ 9,725	1.30%		$ 9,777	1.50%		$ 7,685	1.45%

	2003 vs. 2002 Variance Due to			2002 vs. 2001 Variance Due to		
	Rate[14]	Volume[14]	Total Change	Rate[14]	Volume[14]	Total Change
	(dollars in millions)					
Interest-earning assets:						
Mortgages loans	$ (199)	$ 160	$ (39)	$ (118)	$ 23	$ (95)
Mortgage-related securities in the Retained portfolio	(5,330)	4,342	(988)	(2,201)	5,393	3,192
Total Retained portfolio	(5,529)	4,502	(1,027)	(2,319)	5,416	3,097
Investments	(563)	116	(447)	(980)	1,254	274
Securities purchased under agreements to resell and Federal funds sold	(155)	251	96	(468)	205	(263)
Total interest-earning assets	$(6,247)	$ 4,869	$(1,378)	$(3,767)	$ 6,875	$ 3,108
Interest-bearing liabilities:						
Short-term debt	$ 1,849	$ (331)	$ 1,518	$ 4,670	$ 83	$ 4,753
Long-term debt	2,725	(3,471)	(746)	2,416	(6,259)	(3,843)
Total debt securities	4,574	(3,802)	772	7,086	(6,176)	910
Due to Participation Certificate investors	110	(515)	(405)	66	(275)	(209)
Total interest-bearing liabilities	4,684	(4,317)	367	7,152	(6,451)	701
Income (expense) related to derivatives	984	—	984	(1,732)	—	(1,732)
Total funding of interest-earning assets	$ 5,668	$(4,317)	$ 1,351	$ 5,420	$(6,451)	$(1,031)
Net interest income	$ (579)	$ 552	$ (27)	$ 1,653	$ 424	$ 2,077
Fully taxable equivalent adjustment	9	(34)	(25)	4	11	15
Net interest income/yield (fully taxable equivalent basis)	$ (570)	$ 518	$ (52)	$ 1,657	$ 435	$ 2,092

(1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
(2) For mortgage loans and securities classified as available for sale, we calculate average balances based on their unpaid principal balance plus their associated deferred fees and costs (*e.g.*, premiums and discounts), but exclude the effects of lower of cost or market value adjustments and other-than-temporary impairments. For securities in the Retained portfolio classified as trading, we calculate average balances excluding their mark-to-fair-value adjustments. For securities in the cash and investments portfolio classified as trading, we calculate average balances based on their fair values.
(3) Certain 2002 and 2001 average balances and yields have been adjusted to agree to current year presentation.
(4) May not sum due to rounding.
(5) Average rates for securities classified as available for sale are on the historical cost basis, which is not affected by the change in fair value that is reflected in the AOCI component of Stockholders' equity.
(6) Non-accrual loans are included in average balances.

(7) Rates calculated on a fully taxable equivalent basis were 5.37%, 6.43% and 6.97% for the years ended December 31, 2003, 2002 and 2001, respectively, based upon related income of $29,246 million, $30,253 million and $27,050 million, respectively.

(8) Subsequent to the announcement of our 2003 financial results in our Information Statement Supplement dated June 30, 2004, we revised the average balances of Mortgage-related securities in the Retained portfolio to include certain basis adjustments related to these securities. This revision resulted in a decrease to the Average Balance of Mortgage-related securities in the Retained portfolio of $112 million, $175 million and $121 million for the years 2003, 2002 and 2001, respectively, as well as an increase of 0.01 percent to the 2002 Average Rate related to Mortgage-related securities in the Retained portfolio. This revision also resulted in corresponding changes to the related Rate/Volume Analysis.

(9) Investments consist of Cash and cash equivalents and the Total mortgage-related and non-mortgage-related securities subtotal of Investments as reported on the consolidated balance sheets.

(10) Includes current portion of long-term debt. In 2003, we reclassified the amortization of net realized gains and losses on closed (*i.e.*, terminated or redesignated) cash flow hedges related to long-term debt from Income (expense) related to derivatives to the long-term debt expense line item. These reclassifications, which increased Interest expense long-term debt and decreased Income (expense) related to derivatives, totaled $312 million and $28 million for the years ended December 31, 2002 and 2001, respectively.

(11) Includes amortization of deferred balances related to certain cash flow hedges and the accrual of periodic cash settlements in accordance with the contractual terms of all derivatives in qualifying hedge accounting relationships.

(12) In accordance with interpretive guidance published by the Office of the Chief Accountant of the SEC, we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in a qualifying hedge accounting relationship, from Income (expense) related to derivatives, a component of Net interest income, to Derivative gains (losses), a component of Non-interest income, for all periods presented. These reclassifications, which decreased Derivative gains (losses) and increased Income (expense) related to derivatives, totaled $639 million and $456 million for the years ended December 31, 2002 and 2001, respectively.

(13) Represents the adjustment necessary to calculate the tax-exempt income and yield on a tax equivalent basis. We analyze Net interest income, and the related net interest yield, on a taxable-equivalent basis. This basis includes an adjustment that increases GAAP Net interest income by an amount that would increase interest income on certain tax-exempt securities to a level equivalent to amounts that would incur tax at the 35 percent statutory tax rate. Analysis on a taxable-equivalent basis allows the comparison of ratios related to tax-exempt or tax-advantaged securities to those of fully taxable securities with higher yields.

(14) The combined rate/volume changes are allocated to the individual rate and volume change based on their relative size.

CONSOLIDATED FAIR VALUE BALANCE SHEETS

The consolidated fair value balance sheets in Table 33 present our estimates of the fair value of our recorded assets and liabilities and off-balance-sheet financial instruments as of December 31, 2003 and 2002.

Table 33 — Consolidated Fair Value Balance Sheets[1]

	December 31,			
	2003		2002	
	Carrying Amount[2]	Fair Value[3][4]	Carrying Amount[2]	Fair Value[3]
	(dollars in billions)			
Assets				
Mortgage loans	$ 60.2	$ 62.5	$ 63.9	$ 67.6
Mortgage-related securities[5][6]	600.2	600.4	525.8	526.1
Retained portfolio	660.4	662.9	589.7	593.7
Cash and cash equivalents	23.1	23.1	10.8	10.8
Investments[7]	65.4	65.4	101.2	101.2
Securities purchased under agreements to resell and Federal funds sold	20.6	20.6	23.0	23.0
Derivative assets	16.2	16.2	10.4	10.4
Guarantee asset for Participation Certificates	3.7	4.5	2.4	3.8
Other assets[6][8][9]	14.0	13.2	14.7	14.4
Total assets[9]	$803.4	$805.9	$752.2	$757.3
Liabilities and minority interest				
Total debt securities, net	$739.6	$749.8	$665.7	$683.6
Guarantee obligation for Participation Certificates	2.9	2.4	1.4	2.1
Derivative liabilities	0.4	0.4	1.0	1.0
Reserve for guarantee losses on Participation Certificates	0.1	—	0.1	—
Other liabilities[8][9]	27.0	23.9	50.4	45.1
Minority interests in consolidated subsidiaries	1.9	2.1	2.3	2.6
Total liabilities and minority interest[9]	771.9	778.6	720.9	734.4
Net assets attributable to stockholders				
Preferred stockholders	4.6	4.4	4.6	4.6
Common stockholders	26.9	22.9	26.7	18.3
Total net assets	31.5	27.3	31.3	22.9
Total liabilities and net assets[9]	$803.4	$805.9	$752.2	$757.3

(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 realized from disposition of the assets or settlement of liabilities may vary significantly from the fair values presented.
(2) Carrying amounts equal the amounts reported on our GAAP consolidated balance sheets.
(3) The valuation of financial instruments on the consolidated fair value balance sheets is in accordance with GAAP fair value guidelines prescribed by SFAS 107 and other relevant pronouncements. See "NOTE 16: FAIR VALUE DISCLOSURES" to the consolidated financial statements for more information.
(4) Methodologies employed to calculate fair values are periodically changed on a prospective basis to reflect improvements in the underlying estimation processes. Our estimate of the overall impact of the methodology improvements implemented during 2003 is that they caused a partial offset to the increase in the fair value of net assets during the year.
(5) The fair value of mortgage-related securities reported in this table exceeds the carrying value because the fair value includes PC residuals related to PCs held in the Retained portfolio that are not recognized under GAAP.
(6) Fair value of $0.2 billion related to the credit enhancement on certain manufactured housing asset-backed securities at December 31, 2002 previously reported as Mortgage related securities has been reclassified to Other assets to conform to the current presentation.
(7) Includes mortgage-related securities held in connection with PC market-making and support activities.
(8) Fair values at December 31, 2003 and 2002 include estimated income taxes on the difference between the consolidated fair value balance sheets and the consolidated GAAP balance sheets.
(9) Subsequent to the issuance of our 2003 Information Statement Supplement dated June 30, 2004, we revised certain fair value amounts as of December 31, 2003 related to a correction of the classification of the estimated income taxes on the difference between the consolidated fair value balance sheets and the consolidated GAAP balance sheets. This change resulted in a $0.2 billion decrease to Other assets and Total assets as well as a corresponding $0.2 billion decrease to Other liabilities, Total liabilities and minority interest, and Total liabilities and net assets.

The consolidated fair value balance sheets include all items recorded in the consolidated balance sheets prepared in accordance with GAAP, as well as all off-balance-sheet financial instruments that represent assets or liabilities that are not recorded in the GAAP consolidated balance sheets. These off-balance-sheet items predominantly consist of the unrecognized portion of guarantee contracts associated with PCs issued through our Guarantor Program as well as commitments to purchase multifamily and single-family mortgage loans that will be classified as held-for-investment in the GAAP financial statements and insurance contracts on manufactured housing investments. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for more information.

The valuation of financial instruments on the consolidated fair value balance sheets is in accordance with GAAP fair value guidelines prescribed by SFAS 107 and other GAAP guidance related to fair value measurement. The fair value of a financial instrument is defined in SFAS 107 and other literature as ". . . the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale." The assumptions used to determine or estimate fair values reflect our best judgment regarding appropriate valuation methods.

Under SFAS 107 and other GAAP guidance, the method used to estimate fair value for each type of financial instrument depends on the reliability and availability of relevant market data. For financial instruments with active markets and readily available market prices, we may determine fair values based on price quotations obtained from third-party pricing services, broker-dealers or direct market observations, where available. Depending on the reliability and availability of alternative methods of pricing, we may estimate fair values using other appropriate valuation techniques, including estimates of the present value of expected future cash flows using a discount rate commensurate with the risks involved and internal valuation models that incorporate relevant market data inputs obtained from third-party pricing services and broker-dealers. The use of different pricing models and assumptions could produce materially different estimates of fair value. We use the same valuation techniques for preparing the consolidated fair value balance sheets as we do for those elements of our GAAP consolidated financial statements which are recorded at fair value, such as derivatives and securities as well as guarantee assets for a portion of the PC portfolio. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for more information concerning fair value estimates for our GAAP consolidated balance sheets. See "NOTE 16: FAIR VALUE DISCLOSURES" to the consolidated financial statements for more information about our fair value estimates and the valuation methods and assumptions we use to prepare the consolidated fair value balance sheets.

The consolidated fair value balance sheets do not capture all elements of value that are implicit in our operations as a going concern, as they only reflect the values of the current investment and securitization portfolios. For example, the consolidated fair value balance sheets do not consider the value of new investment and securitization business that would likely replace prepayments as they occur. In addition, the consolidated fair value balance sheets also 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, or fair value of net assets, presented in the fair value balance sheets does not represent an estimate of the net realizable, liquidation or market value of Freddie Mac as a whole, nor is this measure comparable to stockholders' equity in accordance with GAAP. In addition, our Core capital for regulatory purposes is generally determined by reference to the value of certain components of capital as reflected on our balance sheet prepared in accordance with GAAP, not the fair value amounts shown in the table above.

We report assets and liabilities that are not financial instruments (such as our property, plant and equipment and deferred taxes), as well as certain financial instruments that are not covered by the SFAS 107 disclosure requirements (such as pension liabilities), at their GAAP carrying amounts in the consolidated fair value balance sheets. We believe these items do not have a significant impact on our overall financial prospects or fair value results.

Key Components of Changes in Fair Value of Net Assets

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

- **Core spread income.** We define core spread income as the income we expect to earn from the spread between mortgage-related investments and debt, calculated on an option-adjusted basis. An option-adjusted spread is an estimate of the yield spread between a given security and a benchmark (*i.e.*, London Interbank Offered Rate, or LIBOR, agency, Treasury) yield curve, after consideration of the security's variability in cash flows across different potential future interest rate scenarios, resulting from any options embedded in the security. Our estimate of core spread income for a given period includes estimated future costs related to the funding and hedging activities that are likely to be required to achieve our risk management objectives for the Retained portfolio.

- **Fee-based income.** This includes the guarantee income from our single-family and multifamily securitization businesses, adjusted to account for estimated default costs, remittance cycle costs and general and administrative costs. Fee-based income also includes delivery fees on some mortgage purchases, fees collected through our automated underwriting service and fee income associated with resecuritization activities.

- **Return on market risk positions.** Our interest-rate risk positions and other risk positions, such as basis risk and volatility risk, produce year-to-year fair value gains or losses that are reflected in fair value of net assets. We monitor the fair value returns associated with these risk positions and reflect our duration and convexity risk positions in our PMVS and duration gap risk estimates. See "RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — *Measurement of Interest-Rate Risk*" for more information.

- **Changes in mortgage-to-debt option-adjusted spread.** Any change in the relationship between the option-adjusted yield on a previously acquired mortgage or mortgage-related asset and the option-adjusted yield on previously issued debt will lead to a change in the fair value of net assets. An increase (widening) in the mortgage-to-debt option-adjusted spread will result in a decrease in the fair value of our net assets. Conversely, a decline (tightening) in mortgage-to-debt option-adjusted spread will result in an increase in the fair value of net assets.

  Given the size of our retained mortgage portfolio, year-to-year changes in mortgage-to-debt option-adjusted spread could have a significant impact on annual fair value results. However, because we generally hold a substantial portion of these assets for the long term and realize core spread income (as described above) over this time frame, we do not believe period-to-period fluctuations in fair value driven by changes in mortgage-to-debt option-adjusted spread will significantly affect the long-term return on our existing Retained portfolio.

- **Change in fair value of guarantee portfolio.** The fair value of the existing guarantee portfolio fluctuates with changes in interest rates and credit expectations. While year-to-year changes in the fair value of the guarantee portfolio may have a significant impact on annual fair value results, we believe that changes in the fair value of our existing guarantee portfolio are not a good indication of long-term fair value expectations because such changes do not reflect the strong probability that replacement business will largely replenish any guarantee fee income lost because of prepayments over time.

Discussion of Fair Value Results

At December 31, 2003, the fair value of net assets (net of tax effect) was $27.3 billion, a $4.4 billion, or 19 percent, increase from December 31, 2002. For the same period, the fair value of net assets attributable to common stockholders (representing the fair value balance sheet total net assets less the fair value of net assets attributable to preferred stockholders) was $22.9 billion, a $4.6 billion or 25 percent, increase from December 31, 2002. The difference between the $4.4 billion increase and the $4.6 billion increase relates to

the change in the fair value of preferred stock. Among the primary contributors to the increase in fair value of net assets in 2003 were core spread income, guarantee fees on the sold portfolio and other fee income.

In 2003, core spread income benefited from Retained portfolio growth of approximately 14 percent. Guarantee fees benefited in 2003 from growth of outstanding PCs held by third parties. Other fee income benefited in 2003 from substantial resecuritization fees related to high demand by investors for REMIC securities. In 2003, there was a significant positive impact to the fair value of net assets as a result of tighter mortgage-to-debt option-adjusted spreads and changes in guarantee portfolio valuation. We believe that while changes in mortgage-to-debt option-adjusted spreads affecting the fair value of the existing Retained portfolio and fair value changes in the existing guarantee portfolio will fluctuate from year-to-year, they will not have a significant impact on the fair value of net assets over the longer term.

Our increase in fair value of net assets during 2003 demonstrates that our investment and risk management discipline can foster fair value growth in a year when there was high interest-rate volatility and a wide range of interest-rate environments. We caution, however, that the strong fair value results achieved in 2003 exceed our long-term expectations for growth in the fair value of net assets.

VOLUME STATISTICS

Table 34 summarizes our purchase and securitization activity for the periods presented.

Table 34 — Volume Statistics[1]

	Year Ended December 31,			
	2003		2002	
	(dollars in millions)			
New business purchases[2]				
Mortgage Purchases				
Single-family:				
30-year fixed-rate[3]	$377,847	53%	$315,375	58%
15-year fixed-rate	239,684	34	153,346	28
ARMs/Floating-Rate[4]	52,556	7	44,917	8
Balloon/Resets	29,714	4	18,531	4
FHA/VA[5]	1,417	—	845	—
RHS	265	—	180	—
Total single-family	701,483	98	533,194	98
Multifamily:				
Conventional	15,292	2	10,654	2
Total multifamily	15,292	2	10,654	2
Total Mortgage Purchases	$716,775	100%	$543,848	100%
Non-Freddie Mac mortgage-related securities purchased for Structured Securities:				
Alternative collateral deals[6]	$ 3,918		$ 14,507	
Structured Securities backed by Ginnie Mae Certificates	539		265	
Non-Freddie Mac mortgage-related securities purchased into the Retained portfolio:				
Fannie Mae	$ 47,806		$ 45,798	
Ginnie Mae	166		820	
Total agency mortgage-related securities	47,972		46,618	
Single-family and other mortgage-related securities	54,109		36,004	
Commercial mortgage backed securities	10,588		8,282	
Mortgage revenue bonds	963		863	
Manufactured housing	—		318	
Total non-agency mortgage-related securities	65,660		45,467	
Total Non-Freddie Mac mortgage-related securities purchased into the Retained portfolio	$113,632		$ 92,085	
Total new business purchases[7]	$834,864		$650,705	
Credit-enhanced portion of mortgage purchases[8][9]	16%		20%	
Percentage of refinance mortgage purchases[10]	81		74	
Average loan-to-value of purchases:[10]				
Refinance mortgages	66		67	
Purchase money mortgages	79		79	
Total purchases	68		70	
Mortgage liquidations[7][11]	$719,321		$464,669	
Mortgage liquidation rate[7][11]	55%		40%	
Securities Settlements:[9]				
Single-family PCs	$704,912		$543,451	
Multifamily PCs	8,337		3,596	
Total	$713,249		$547,047	
Structured Securitizations[12]	$298,118		$331,672	
Freddie Mac securities repurchased into the Retained portfolio[7][13]	$266,989		$192,817	

(1) Based on unpaid principal balances.
(2) Based on our total mortgage portfolio.
(3) Also includes 20-year fixed-rate mortgages.
(4) Includes ARMs with 1-, 3-, 5-, 7- and 10-year initial fixed-rate periods.
(5) Excludes FHA/VA loans that may be collateral for alternative collateral deals.
(6) Includes Structured Securities backed by non-agency securities, which are primarily backed by subprime mortgage loans. To a lesser extent, these securities are backed by FHA/VA loans and home equity mortgage loans.
(7) For the year ended December 31, 2002, total new business purchases, mortgage liquidations and Freddie Mac securities repurchased into the Retained portfolio have been revised for a $8,360 million reduction, $3,660 million increase and $7,626 million increase, respectively. These revisions are attributable to (a) the addition of activity related to Structured Securities backed by Ginnie Mae Certificates, and (b) corrections primarily attributable to misclassifications of certain securities between Freddie Mac mortgage-related securities and non-Freddie Mac mortgage-related securities.
(8) Credit enhancements include loans for which the lender or a third party has retained primary default risk by pledging collateral or agreeing to accept losses on loans that default. In some cases, the lender's or the third party's risk is limited to a specific level of losses at the time the credit enhancement becomes effective.
(9) Excludes Structured Securities backed by Ginnie Mae Certificates.
(10) Amounts exclude alternative collateral deals and Structured Securities.
(11) Excludes sales of non-Freddie Mac mortgage-related securities.
(12) Includes activity related to multi-class Structured Securities, primarily REMICs as well as principal-only strips and other Structured Securities. These amounts exclude resecuritizations of PCs into single-class securities.
(13) Excludes Freddie Mac securities purchased in connection with PC market making and support activities, which are reflected in the "Investments" caption on the consolidated balance sheets.

Our 2003 business volume was the highest in our history. Interest rates for fixed-rate mortgages declined during 2002 and through the first half of 2003, resulting in a surge of mortgage refinancing activity during both years. As a result of these market trends, purchase volume increased by nearly 30 percent from 2002 to 2003. Refinanced mortgages represented 81 percent of our total 2003 purchases, up from 74 percent in 2002. Mortgage lenders tend to deliver more fixed-rate residential mortgages to the GSEs as compared to ARM/floating-rate products. Fixed-rate mortgages represented 87 percent of our mortgage purchases for 2003, up from 86 percent in 2002. Fixed-rate 15-year mortgage loan volume rose in 2002 and 2003, as declining interest rates increased the number of borrowers that qualified for and chose this mortgage product, while the 30-year fixed-rate portion of our volume activity declined from 58 percent in 2002 to 53 percent in 2003.

The liquidation rate on the total mortgage portfolio increased to 55 percent for 2003, compared to 40 percent for 2002. The high liquidation rates in 2003 and 2002 reflect accelerated borrower prepayments due to low fixed rates during 2002 and the first half of 2003, as evidenced by the high percentage of refinance mortgage purchases in 2003 and 2002.

The percentage of credit-enhanced purchases decreased to 16 percent for 2003 from 20 percent for 2002 due primarily to a decline in the number of loans purchased that are covered by primary mortgage insurance. The portion of our purchases with primary mortgage insurance declined primarily because primary mortgage insurance is not required on loans with low loan-to-value ratios. The low loan-to-value ratio on purchases resulted from the increases in home prices and rise in refinance activity in 2003. Our ability and desire to utilize credit enhancements will depend on our evaluation of the credit quality of new business purchase opportunities and the future availability of effective credit enhancements at prices that permit an attractive return. See "RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for more information.

A significant portion of our mortgage purchase volume is generated from several key mortgage lenders that have entered into special business arrangements with us. See "BUSINESS — Mortgage Purchase and Guarantee Activity" for more information about these relationships and consequent risks.

Volumes associated with the issuance of Structured Securities, particularly REMICs, vary based on market conditions that affect demand by us and other investors. Our structured securitization activity (pertaining to REMICs, Structured Securities backed by non-agency securities and interest-only and principal-only strips) was high in 2003 and 2002 at $298 billion and $332 billion, respectively. The steep yield curve and significant refinance activity in 2002 and 2003 resulted in continued strong investor demand for REMIC securities and an increased supply of REMIC collateral.

Table 35 summarizes the characteristics of the single-family loan purchases (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by Ginnie Mae Certificates) by original loan-to-value ratio range, credit score, loan purpose, property type and occupancy type. See "RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risk*" for definitions of those risk characteristics.

Table 35 — Characteristics of Purchases into the Single-Family Mortgage Portfolio(1)

	Year Ended December 31,		
Original Loan-to-Value Ratio Range(2)	**2003**	**2002**	**2001**
0% to 60%	29%	25%	18%
Above 60% to 70%	19	16	14
Above 70% to 80%	40	43	46
Above 80% to 90%	7	9	11
Above 90% to 95%	4	6	9
Above 95%	1	1	2
Total	100%	100%	100%
Weighted average original loan-to-value ratio	68%	70%	74%
Credit Score(3)			
Less than 620	3%	4%	4%
620 to 659	8	9	11
660 to 699	17	18	19
700 to 739	23	24	24
740 and above	49	44	41
Not Available	—	1	1
Total	100%	100%	100%
Weighted average credit score	729	722	718
Loan Purpose(3)			
Purchase	19%	26%	38%
Cash-out refinance	26	29	26
Other refinance	55	45	36
Total	100%	100%	100%
Property Type(3)			
1 unit	98%	98%	98%
2-4 units	2	2	2
Total	100%	100%	100%
Occupancy Type(3)			
Primary residence	95%	94%	94%
Second/vacation home	3	3	3
Investment	2	3	3
Total	100%	100%	100%

(1) Based on purchase activity related to the single-family mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by Ginnie Mae Certificates), which totaled $701 billion, $533 billion and $384 billion at December 31, 2003, 2002 and 2001, respectively.
(2) Our charter requires that mortgage loans purchased with loan-to-value ratios above 80 percent be covered by mortgage insurance or other credit protections.
(3) See "RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risk*" for more information.

Single-family mortgage loans purchased with loan-to-value ratios above 80 percent have decreased from 22 percent at December 31, 2001 to 16 percent and 12 percent at December 31, 2002 and 2003, respectively. In addition, the weighted average loan-to-value ratio of the mortgage loans purchased has decreased from 74 percent at December 31, 2001 to 70 percent and 68 percent at December 31, 2002 and 2003, respectively.

The lower loan-to-value ratios in 2002 and 2003 are primarily the result of house-price appreciation combined with the surge in refinance activity in these years.

The proportion of mortgage loans purchased resulting from refinancing transactions increased to a total of 81 and 74 percent at December 31, 2003 and 2002, respectively, from 62 percent at December 31, 2001. This increase in refinance activity is a result of the low interest rates experienced in 2002 and the first half of 2003.

The quality of mortgage loans purchased in 2003 and 2002 continued to be strong. The strong credit quality of borrowers is evidenced by the high average credit score on mortgage loans purchased of 729, 722 and 718 at December 31, 2003, 2002 and 2001, respectively. The proportion of one-unit properties in our mortgage loan purchase volume remained the same over the past three years, accounting for 98 percent at December 31, 2003, 2002 and 2001. The proportion of primary and secondary residences in our mortgage loan purchase volume remained stable over the past three years, accounting for 98 percent at December 31, 2003 and 97 percent at both December 31, 2001 and 2002.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

Our business activities present liquidity demands driven by maturities and repurchases of our debt, purchases of mortgage loans, mortgage-related securities and other investments, payments of principal and interest to PC and Structured Securities holders, general operations and the payment of dividends to our stockholders. Our sources of cash to meet the needs of our business activities and general operations include:

- Issuances of long-term and short-term debt;
- Receipts of principal and interest on securities we hold or mortgages we have securitized and sold;
- Sales of securities we hold, particularly those in the cash and investments portfolio;
- Borrowings against mortgage-related securities and other investment securities we hold;
- Cash flows from operating activities; and
- Issuances of common and preferred stock.

We measure our cash flow position on a daily basis, netting uses of cash (principally, the settlement of mortgage and non-mortgage investment security purchases, principal and interest payments on debt and mortgage securities, net payments on derivative instruments and other operating cash flows) with sources of cash (principally, the settlement of debt borrowings and principal and interest receipts on mortgage and non-mortgage investment securities held in portfolio and mortgages we have securitized and sold). The net cash position is managed over a rolling forecasted period of 90 days, so that the amount of debt funding needed to cover expected negative balances does not adversely affect our overall funding levels. This daily management of our liquidity is in accordance with the *Liquidity Management and Contingency Planning* voluntary commitment. See "VOLUNTARY COMMITMENTS" for further information.

Depending on market conditions and the mix of our derivatives employed in connection with our ongoing risk management activities, our derivative portfolio can be either a net source of or a net use of cash. For example, depending on the prevailing interest-rate environment, interest-rate swap agreements could cause us either to make interest payments to the counterparty or to receive interest payments from the counterparty. Purchased options require us to pay a premium while written options allow us to receive a premium. Also, the legal proceedings discussed in "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements may result in a use of cash.

To refinance maturing debt, we depend on the continuing willingness of investors to purchase our debt securities (for more information regarding the maturity profile of our outstanding debt securities, see "Table 40 — Total Capitalization"). Our inability to prepare timely consolidated financial statements, as discussed in "RISK MANAGEMENT — Operational Risk," or any change in legislative or regulatory exemptions as described in "BUSINESS — Regulation and Governmental Relationships," could adversely affect our access to some debt investors, thereby potentially increasing our debt funding costs. However, because of our financial performance and our regular and significant participation as an issuer in the funding markets, our sources of liquidity have remained adequate to meet our needs and we anticipate that they will continue to do so. We will not issue common stock until we have returned to timely financial reporting. In addition, our ability to issue preferred stock or subordinated debt may be limited during this period.

Under our charter, the Secretary of the Treasury has discretionary authority to purchase our obligations up to a maximum of $2.25 billion principal balance outstanding at any one time. However, we do not rely on this authority as a source of liquidity to meet our obligations. See "BUSINESS — Regulation and Governmental Relationships" for more information.

Debt Securities

We finance our purchases of mortgage loans and mortgage-related securities primarily through the issuance of both long-term and short-term debt. Table 36 below summarizes the par value of our debt security issuances based on settlement date during 2003 and 2002.

Table 36 — Debt Security Issuances

Debt Securities Products	Year Ended December 31, 2003	2002
	(dollars in millions)	
Short-term Reference Bills® and discount notes	$ 784,614	$1,370,161
Medium-term Notes	213,924	201,803
U.S. dollar denominated Reference Notes®	54,000	78,743
€Reference Notes®	4,347	13,793
Subordinated debt	—	2,500
Total debt securities issued	$1,056,885	$1,667,000

See "BUSINESS — Portfolio Investment — *Debt Securities*" for more information on our debt programs.

On an annual basis for the upcoming calendar year, we publish financing calendars, which are intended to provide clarity and transparency with regard to the timing of new debt issues and reopening of prior issues, the anticipated size of individual offerings and settlement dates. All Reference Notes® securities, €Reference Notes® securities and Reference Bills® securities issued during 2003 and the first eight months of 2004 were issued in accordance with our previously announced financing calendars.

The 2004 financing calendars underscore our goal of aligning our interests with investors while also ensuring that we have the flexibility to offer the marketplace securities of the appropriate size and maturity. In addition, we have supplemented our calendars by publishing the "Quarterly Funding Announcement & Summary," or QFAS, which promotes additional transparency and predictability by detailing our funding activity from the previous quarter and outlining expectations for the upcoming quarter. The QFAS is available on our website www.FreddieMac.com. (We are providing this reference to the QFAS solely for the information of interested persons. We are not using references to the QFAS here or elsewhere in this Information Statement to incorporate additional information into this Information Statement.)

By adhering to our financing calendars, we are able to provide our debt investors with a predictable source of investment opportunities. However, there is no assurance that we will be able to continue to adhere to our financing calendars in the future. In order to continue our debt offerings as scheduled and properly manage our asset/liability mix, we regularly conduct repurchases of outstanding debt securities. Our repurchase operations support the transparency, liquidity, and predictability of Reference Notes® securities, €Reference Notes® securities and callable debt securities. During 2003 and 2002, we repurchased approximately $24.8 billion and $18.9 billion, respectively, of our outstanding Reference Notes and €Reference Notes. In addition, primarily as a response to declining interest rates, we called approximately $153.0 billion and $99.3 billion of our higher-rate long-term callable debt during 2003 and 2002, respectively. From time to time, we may also enter into transactions in which we exchange newly issued debt securities for similar outstanding debt securities held by investors. These transactions are not accounted for as repurchases, but rather as debt exchanges.

Our ability to access the capital markets and other sources of funding, as well as our cost of funds, are highly dependent upon our credit ratings. Table 37 indicates our current credit ratings as of September 1, 2004.

Table 37 — Freddie Mac Credit Ratings

	Rating Agency		
	Standard & Poor's	Moody's	Fitch
Senior long-term debt	AAA	Aaa	AAA
Short-term debt	A-1+	Prime-1	F-1+
Subordinated debt	AA–	Aa2	AA–Watch Negative
Preferred stock	AA–	Aa3	AA–Watch Negative

In addition to the ratings described in Table 37, Standard & Poor's, or S&P provides a "Risk-To-The-Government" rating that measures our ability to meet our debt obligations and the value of our franchise in the absence of any implied government support. Our "Risk-To-The-Government" rating was AA- at September 1, 2004. Moody's also provides a "Bank Financial Strength" rating that represents Moody's opinion of our intrinsic safety and soundness and, as such, excludes certain external credit risks and credit support elements. Ratings under this measure range from A, the highest, to E. "Our Bank Financial Strength" rating was A- at September 1, 2004.

Equity Securities

During the first eight months of 2004 and all of 2003, we did not issue or redeem any equity securities. During 2002, we redeemed $287 million of 6.125 percent preferred stock, issued in November 1996, and effectively replaced it with a 5.81 percent perpetual non-cumulative preferred stock issuance with a redemption value of $300 million, raising approximately $13 million in net proceeds. During 2003, we did not repurchase any common shares. We repurchased approximately 9.1 million common shares during 2002 for approximately $555 million.

Cash and Investments Portfolio

To protect ourselves against temporary disruptions in our ability to obtain funding for our business operations, we maintain a cash and investments portfolio. The investments in this portfolio consist of liquid non-mortgage-related securities and mortgage-related securities that can be sold or financed to:

- Manage recurring cash flows and meet other cash management needs;
- Maintain capital reserves to meet mortgage funding needs;
- Provide diverse sources of liquidity; and
- Help manage the interest-rate risk inherent in mortgage-related assets.

Through this portfolio, we are also able to strategically utilize our available capital. This portfolio is important to our financial management and our ability to provide liquidity and stability to the mortgage market.

The non-mortgage-related securities in the cash and investments portfolio consist principally of asset-backed securities, corporate debt securities, and other marketable assets that can be readily converted to cash. The non-mortgage investments in this portfolio may expose us to institutional credit risk and the risk that the investments will decline in value due to market-driven events such as credit downgrades or changes in interest rates and other market conditions. See "RISK MANAGEMENT — Credit Risks — *Institutional Credit Risk*" for more information. The mortgage-related securities in the cash and investments portfolio consist primarily of assets held by our SS&TG business unit.

Table 38 summarizes the mortgage-related and non-mortgage-related securities held in the cash and investments portfolio at December 31, 2003 and 2002. In addition, information regarding maturities and credit ratings is provided to assist in understanding our credit risk related to the cash and investments portfolio.

Table 38 — Mortgage-Related and Non-Mortgage-Related Securities in the Cash and Investments Portfolio

	December 31, 2003			December 31, 2002		
	Ending Balance at Fair Value	Average Maturity (Months)	% of Portfolio A Rated or Better[1]	Ending Balance at Fair Value	Average Maturity (Months)	% of Portfolio A Rated or Better[1]
	(dollars in millions)					
Non-mortgage-related securities						
Asset-backed securities[2]	$16,596	N/A	100%	$ 34,694	N/A	100%
Debt securities issued by the U.S. Treasury and other government corporations and agencies	—	—	—	12,493	136	100
Corporate debt securities	4,924	36	60	10,102	33	64
Obligations of states and municipalities	9,494	323	100	6,641	307	100
Commercial paper	150	1	100	2,240	1	100
Preferred stock	64	55	100	249	19	92
Subtotal	31,228		94%	66,419		94%
Other non-mortgage-related securities held for PC market-making and support activities[3]	1,314			2,409		
Other mortgage-related securities held for PC market-making and support activities[4]	32,812			32,374		
Total mortgage-related and non-mortgage-related securities in "Cash and Investments" per consolidated balance sheets	$65,354			$101,202		

(1) Credit ratings are designated by at least two nationally recognized rating agencies.
(2) Consists primarily of securities that can be prepaid prior to their contractual maturity without penalty. Maturity information related to these securities is not included because the contractual maturity does not represent the expected lives of the securities.
(3) See "BUSINESS — PC Market-Making and Support Activities" for more information.
(4) The majority of these securities are agency mortgage-related securities and thus the disclosures concerning average maturity and rating are not provided.

For a discussion of the decline in the balance of non-mortgage-related securities during 2003, see "CONSOLIDATED BALANCE SHEETS ANALYSIS — Cash and Investments."

Contractual Obligations

"Table 39 — Specified Contractual Obligations by Year" includes aggregated information about our specified contractual obligations as of December 31, 2003. These contractual obligations affect our short- and long-term liquidity and capital resource needs. "Table 39 — Specified Contractual Obligations by Year" includes information about undiscounted future cash payments due under specified contractual obligations, aggregated by type of contractual obligation, including the contractual maturity profile of our consolidated debt securities and other liabilities reported on our consolidated balance sheets and our operating leases at December 31, 2003. In addition, our contractual obligations include other purchase obligations that are enforceable and legally binding. For purposes of "Table 39 — Specified Contractual Obligations by Year," purchase obligations are included through the termination date specified in the respective agreements, even if the contract is renewable. Many of the purchase agreements for goods or services include clauses that would allow us to cancel the agreement prior to the expiration of the contract within a specified notice period; however, the table includes such obligations without regard to such termination clauses (unless actual notice of our intention to terminate the agreement has been communicated to the counterparty).

Table 39 excludes guarantee obligations, which represent our obligations to stand ready to perform under our guarantees of the payment of principal and interest of certain PCs and Structured Securities, as the amount and timing of payments under these arrangements are generally contingent upon the occurrence of

future events. The liabilities on our consolidated balance sheets associated with our guarantee obligations are included in the caption Guarantee obligation for Participation Certificates. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for additional information about our guarantee obligations.

The funding policy for our qualified pension plans is generally to contribute the maximum amount deductible for federal income tax purposes each year. We expect to contribute approximately $12 million to our qualified pension plans during 2004. This expected contribution is included in the Other liabilities caption in Table 39. The estimated pension plan contributions are subject to change since contribution decisions are affected by various factors such as market performance, regulatory requirements and management's ability to change funding policy. For additional information regarding our retirement benefit obligations see "NOTE 15: EMPLOYEE BENEFITS" to the consolidated financial statements.

Table 39 — Specified Contractual Obligations by Year (as of December 31, 2003)

	Total	2004	2005	2006	2007	2008	Thereafter
			(dollars in millions)				
Long-term debt securities[1]	$550,875	$ 80,610	$90,840	$73,290	$36,958	$50,675	$218,502
Short-term debt securities[1]	212,035	212,035	—	—	—	—	—
Operating lease obligations	98	11	11	10	10	10	46
Purchase obligations:							
Purchase commitments[2]	33,923	33,923	—	—	—	—	—
Other purchase obligations[3]	331	223	45	26	20	17	—
Other liabilities reflected on our consolidated balance sheets:							
Due to Participation Certificate investors	13,205	13,205	—	—	—	—	—
Accrued interest payable	7,345	7,345	—	—	—	—	—
Other liabilities[4]	2,663	1,201	585	322	294	78	183
Total specified contractual obligations	$820,475	$348,553	$91,481	$73,648	$37,282	$50,780	$218,731

(1) The amounts presented for long-term debt obligations exclude net discounts of approximately $23 million. Callable debt is included in the table at its contractual maturity. For additional information about long-term and short-term debt securities see "NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS" to the consolidated financial statements.
(2) Purchase commitments represent our obligations to purchase mortgage loans, mortgage-related securities and various debt securities from third parties.
(3) Other purchase obligations primarily include obligations related to consulting, outsourcing and other costs.
(4) Other liabilities primarily represent obligations to make delayed equity contributions to low-income housing tax credit partnerships that are unconditional and legally binding. This caption also includes $90 million of other liabilities included in the 2004 column for which the timing of payments is uncertain.

At December 31, 2003, we used our derivative transactions to manage our exposures to interest-rate changes and other market risks. Such transactions may require cash settlement in future periods and are not reflected on Table 39. See "Table 49 — Derivatives Fair Values and Maturities," which describes the notional amount and fair value for each derivative type and the maturity profile of the positions in "RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks."

Capital Resources

We manage our capital resources to provide attractive returns on our common equity, maintain sufficient capital to satisfy internal capital adequacy standards as well as regulatory capital requirements, and absorb unforeseen losses that might arise in fulfilling our obligations and conducting our business programs.

Table 40 sets forth our capitalization as of the dates presented.

Table 40 — Total Capitalization

	December 31,	
	2003	2002
	(dollars in millions)	
Debt securities:		
Due within one year:		
Short-term debt securities	$212,035	$194,044
Current portion of long-term debt	83,227	50,385
Total due within one year	295,262	244,429
Due after one year	438,738	415,662
Subordinated borrowings due after one year[1]	5,613	5,605
Total due after one year	444,351	421,267
Total debt securities, net	739,613	665,696
Stockholders' equity	31,487	31,330
Total capitalization	$771,100	$697,026

(1) The year-over-year increase in the balance of subordinated borrowings results from principal accretion related to zero-coupon subordinated debt.

See "NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS" and "NOTE 9: STOCKHOLDERS' EQUITY" to the consolidated financial statements for further information.

We engage in transactions and issue or repurchase debt obligations on an ongoing basis, all of which will cause our total capitalization to change. Therefore, on any date after December 31, 2003, our total capitalization will differ (perhaps substantially) from the figures contained in this capitalization table.

Table 41 summarizes the components of our Core capital. Core capital excludes AOCI, net of taxes, consistent with our regulatory capital requirements, which are described under "Capital Adequacy" below.

Table 41 — Summary of Core Capital

	December 31,	
	2003	2002
	(dollars in millions)	
Common stock:		
Par value	$ 152	$ 152
Additional paid-in capital	814	744
Preferred stock (at redemption value)	4,609	4,609
Retained earnings	28,837	24,955
Treasury stock, at cost	(1,427)	(1,470)
Core capital	$32,985	$28,990

Capital Transactions

During 2003, we added approximately $4.0 billion to Core capital primarily from net income, partially offset by the payment of common and preferred stock dividends. During 2002, we added approximately $8.8 billion to Core capital primarily from net income and one preferred stock issuance, partially offset by a preferred stock redemption, common stock repurchases and payment of common and preferred stock dividends.

Our Board of Directors approved a quarterly dividend per common share of $0.30 for the first, second and third quarters in 2004, an increase of 15 percent over the $0.26 quarterly dividend paid each quarter during 2003. We paid a quarterly dividend per common share of $0.22 in 2002. Dividends declared and paid in any quarter will be determined by our Board of Directors after considering our financial strength and capital surpluses, among other factors.

In addition, under the capital monitoring framework established by OFHEO in January 2004, we are required to obtain prior written approval from the Director of OFHEO before engaging in certain capital transactions, including the repurchase of any shares of common stock, redemption of any preferred stock or payment of preferred stock dividends above stated contractual rates. We also must 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.

In periods of timely financial reporting, when we are adequately capitalized and attractive investment opportunities are not available, we will consider returning capital to our stockholders through dividends or common stock repurchases. In addition, we periodically reissue treasury stock to employees and non-employee directors as part of our stock-based compensation plans. See "NOTE 11: STOCK-BASED COMPENSATION" to the consolidated financial statements for a description of these plans. The amount of capital available to distribute to our stockholders will be affected primarily by:

- Mortgage portfolio growth opportunities;
- Our assessment of the adequacy of our capital; and
- Regulatory capital standards and supervisory requirements.

All common stock repurchases have been made as part of the stock repurchase plan approved by our Board of Directors on September 5, 1997. The current plan allows repurchases of common stock not to exceed 5 percent of shares outstanding as of September 5, 1997, which was approximately 34 million shares. At December 31, 2003, approximately 13 million common shares remained available for repurchase under this plan. During periods when current consolidated financial statements are available, the frequency and amount of repurchases will depend on market conditions. During 2003 and the first eight months of 2004, we did not repurchase any common shares. We repurchased approximately 9.1 million shares of common stock during 2002 for approximately $555 million. We do not expect to engage in common share repurchases until after we resume timely financial reporting. In addition, we may not be able to issue or redeem preferred stock or subordinated debt until we resume timely financial reporting and therefore, changes in Core capital will generally be limited to net income and dividends. See "BUSINESS — Regulation and Governmental Relationships — *Regulatory Matters* — OFHEO" for a discussion of the framework established by OFHEO for monitoring our capital.

Table 42 details, as of December 31, 2003, our outstanding preferred stock issuances that are redeemable at our option at December 31, 2003, and redeemable beginning in 2004 or later.

Table 42 — Preferred Stock

Earliest Optional Redemption Dates[1][2]	Annual Dividend Rate	Redemption Value[1]
		(dollars in millions)
Issuances redeemable at December 31, 2003		
October 27, 1998	5.81%	$ 150
October 30, 2000	5.3%	200
June 30, 2001	variable	250
June 30, 2002	6.14%	600
March 31, 2003	5.00%	400
March 31, 2003[3]	variable	325
March 31, 2003[4]	variable	230
June 30, 2003[5]	variable	201
September 30, 2003	variable	220
September 30, 2003	5.1%	400
		2,976
Issuances redeemable in 2004 or later		
March 31, 2004	5.1%	150
December 31, 2004[6]	variable	288
June 30, 2006	6%	173
December 31, 2006	5.7%	300
March 31, 2007	5.81%	300
June 30, 2009	5.79%	250
March 31, 2011	5.81%	172
		1,633
Total Preferred Stock at Redemption Value[7]		$4,609

(1) Optional redemption on or after dates indicated.
(2) As long as the capital monitoring framework established by OFHEO in January 2004 remains in effect, any preferred stock redemptions will require prior approval by OFHEO (see "BUSINESS — Legislative and Regulatory Environment — *Regulatory Matters* — Capital Requirements and Capital Distribution Rules").
(3) Optional redemption on March 31, 2003 and on March 31 every two years thereafter.
(4) Optional redemption on March 31, 2003 and on March 31 every year thereafter.
(5) Optional redemption on June 30, 2003 and on June 30 every two years thereafter.
(6) Optional redemption on December 31, 2004 and on December 31 every five years thereafter.
(7) No preferred stock was redeemed in 2003 or the first eight months of 2004.

Capital Adequacy

We regularly assess the adequacy of our capital to confirm that we hold capital sufficient to satisfy all of our financial obligations, even if economic circumstances deteriorate unexpectedly and severely.

The GSE Act establishes our capital standards, and OFHEO has issued regulations that set our minimum, critical and risk-based capital requirements. We operate with the intention that our capital exceeds all regulatory requirements. See "NOTE: 10 REGULATORY CAPITAL" to the consolidated financial statements for a discussion of the regulatory risk-based, minimum and critical capital requirements and the capital monitoring framework mandated by OFHEO.

"Table 43 — Regulatory Capital Requirements" summarizes our regulatory capital requirements and surpluses at December 31, 2003 and 2002. Amounts for 2003 are as currently reported to OFHEO.

Table 43 — Regulatory Capital Requirements

	December 31,	
	2003	2002
	(dollars in millions)	
Minimum capital requirement	$23,774	$22,339
Core capital[1][2]	32,985	28,990
Minimum capital surplus[1]	9,211	6,651
Critical capital requirement	12,097	11,369
Core capital[1][2]	32,985	28,990
Critical capital surplus[1]	20,888	17,621
Risk-based capital requirement[3]	5,426	4,743
Total capital[3][4]	33,436	24,222
Risk-based capital surplus[3]	28,010	19,479

(1) For 2003, Core capital and minimum and critical capital surpluses have been amended from amounts previously reported to OFHEO to incorporate adjustments reflected in our consolidated financial statements. The 2003 minimum and critical capital surplus amounts are estimates and have been revised from amounts included in our Information Statement Supplement dated June 30, 2004 to reflect a loss contingency reserve related to proceedings arising from our previous restatement. OFHEO is the authoritative source of the capital calculations that underlie our capital classification. See "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements for further information.

(2) Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), par value of outstanding perpetual preferred stock, additional paid in capital and retained earnings, as determined in accordance with GAAP.

(3) Risk-based and Total capital amounts are those calculated by OFHEO prior to the issuance of our 2003 and 2002 financial results. OFHEO determined not to recalculate the risk-based capital amounts because the minimum capital requirement remained the primary factor for our classification as adequately capitalized.

(4) Total capital includes Core capital and general reserves for mortgage and foreclosure losses.

OFF-BALANCE SHEET ARRANGEMENTS

Off-Balance Sheet Transactions

In the ordinary course of business, we fulfill our statutory purposes as a GSE of providing stability and liquidity in the secondary market for residential mortgages, as well as responding appropriately to changes in the private capital markets, by engaging in various transactions. These transactions enable us to:

- Maintain the lowest possible cost of financing for our mortgage investments;
- Bring efficiency to the mortgage market;
- Manage interest-rate risk, credit risks, other business and market risks; and
- Enhance our liquidity and capital resources.

Financial instruments created through these transactions may or may not be recorded on our consolidated balance sheets at their fair value or on a cost basis. A transaction's contractual or notional amount usually does not equal the related fair value or carrying amount.

As discussed in "BUSINESS — Business Overview," our participation in the secondary mortgage market includes issuing PCs to third party investors through securitization. PCs represent undivided interests in pools of mortgage loans that are backed by either single-family or multifamily mortgage loans. We also resecuritize Structured Securities, which represent undivided interests in PCs or other mortgage-related securities issued by either Ginnie Mae or non-agency issuers. In each case, we provide our credit guarantees with respect to the payment of principal and interest on issued PCs or Structured Securities. In these transactions, mortgage-related securities that back PCs and Structured Securities held by third parties are not reflected as our assets under GAAP. However, we do retain an obligation to guarantee the payment of principal and interest on issued PCs and Structured Securities, which usually results in the recognition of a guarantee asset and guarantee obligation on our consolidated balance sheets.

Most of our credit guarantee activity occurs through the Guarantor Program in the form of mortgage swap transactions. In a mortgage swap transaction, a mortgage lender delivers mortgages to us in exchange for our PCs, which represent undivided interests in those same mortgages for which we guarantee the payment of principal and interest. We do not receive any consideration for the underlying mortgages in a mortgage swap transaction other than the associated management and guarantee fee and delivery or credit fees for higher-risk mortgages for our guaranteeing and administering the payment of principal and interest on the PCs.

Most of the remaining credit guarantee activity occurs through the Cash Window Program. In a cash transaction to purchase mortgage loans, we decide whether to hold the mortgage loans in our Retained portfolio and finance them by issuing debt and equity securities, or sell them in the secondary market in the form of issued PCs that carry our guarantee of payment of principal and interest. Those mortgage loans that are purchased through the Cash Window Program that we do not retain are pooled together with other single-family mortgage loans that are received in connection with MultiLender Swap transactions. These PCs are backed by mortgage loans delivered to us by more than one third party. We may contribute mortgage loans to MultiLender pools from which PCs are then issued and delivered to third parties. In this case, our contributions are accounted for as a partial sale, while the remaining portions of such PCs and transfers are accounted for consistent with the accounting for PCs issued through the Guarantor Program. Issued PCs that are not delivered to third party lenders through the MultiLender Program are sold through an auction for cash consideration. We also receive the ongoing management and guarantee fee for PCs issued through these programs.

In addition to the issuance and transfer of PCs to third parties, we also sell PCs from our portfolio in resecuritized form. More specifically, we issue single- and multi-class Structured Securities that are backed by securities held in our portfolio and subsequently transfer such Structured Securities to third parties in exchange for cash consideration, or in exchange for PCs and other mortgage-related securities that are delivered to us by third party dealers who sell such Structured Securities to mortgage security investors. We generally earn resecuritization fees in connection with the creation of Structured Securities and can earn the ongoing management and guarantee fee for certain Structured Securities issued. Our principal exposure on

Structured Securities relates only to that portion of resecuritized assets that are represented by non-Freddie Mac mortgage-related securities.

See "Table 3 — Freddie Mac Single-Class and Multi-Class PCs and Structured Securities Based on Unpaid Principal Balances" for our total PCs and Structured Securities outstanding (held by third parties) as of December 31, 2003 and 2002. As indicated in Table 3, our outstanding PCs and Structured Securities also include:

- Structured Securities backed by Ginnie Mae Certificates;
- Tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties for which we provide our guarantee of the payment of principal and interest;
- Multifamily mortgage loans that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds for which we provide our guarantee of the payment of principal and interest (see "NOTE 4: FINANCIAL GUARANTEES" to the consolidated financial statements); and
- Mortgage loans held by third parties for which we provide a credit guarantee.

For our purchase and securitization activity for 2003 and 2002, see "Table 34 — Volume Statistics."

The accounting policies we apply to our credit guarantee activities significantly affect the volatility of our reported earnings through the initial recognition of the fair value of guarantee assets and guarantee obligations in connection with sales of PCs and Structured Securities, the recognition of subsequent gains or losses from the change in fair value of guarantee assets and PC residuals generated from such sales and the repurchase and sale of PCs into and out of our Retained portfolio and our cash and investments portfolio. See "CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss)" for an analysis of management and guarantee income and other affected consolidated statements of income captions related to our credit guarantee activities. See "CONSOLIDATED BALANCE SHEETS ANALYSIS" for discussion of our guarantee assets and guarantee obligations. The accounting and financial results for our securitization transactions (including gains and losses on transfers of PCs and Structured Securities that are accounted for as sales and periodic cash flows on transfers of securitized interests and corresponding retained interests) and the significant assumptions used to determine the gains or losses from such transfers that are accounted for as sales are discussed in "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to the consolidated financial statements. The maximum potential amount of future principal payments we could be required to make in connection with the unpaid principal balance of all PCs and Structured Securities held by third parties totaled $752 billion and $730 billion at December 31, 2003 and 2002, respectively. See "NOTE 4: FINANCIAL GUARANTEES" to the consolidated financial statements for additional information.

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

Our PCs and Structured Securities are an integral part of our mortgage purchase program and any decline in the price performance of or demand for our PCs or a combination thereof could have a material adverse effect on the profitability of our new credit guarantee business. In the second quarter of 2003, the price of and demand for our PCs weakened relative to comparable Fannie Mae securities. As discussed in "BUSINESS — Mortgage Security Performance and Other Market Support Activities" and "EXECUTIVE SUMMARY — 2003 Business Volumes," in June 2003, we began taking action to improve our market share by broadly implementing a pricing feature that adjusts the contract guarantee fee on new business by the security price execution difference. During the first eight months of 2004, our PC prices have strengthened compared to the second half of 2003.

Other

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

We are a party to numerous entities that are considered to be variable interest entities under FIN 46-R. These variable interest entities include low-income multifamily housing tax credit partnerships, certain Structured Securities trusts (T-Series Trusts or alternative collateral deals), and certain asset-backed investment entities. Our adoption of the revision of FIN 46, or FIN 46-R, for 2003 year-end reporting had no effect on our consolidated financial statements. As of December 31, 2003, we were not required to consolidate any variable interest entities under FIN 46-R. See "NOTE 3: VARIABLE INTEREST ENTITIES" to the consolidated financial statements for additional information related to our significant variable interests in these variable interest entities.

As part of our credit guarantee business, we routinely enter into forward purchase and sale commitments for mortgage loans, mortgage-related securities and agency debt. Pursuant to SFAS 133, a portion of these commitments are accounted for as derivatives under GAAP, with their fair value reported as either Derivative assets, at fair value or Derivative liabilities, at fair value on the consolidated balance sheets. See "RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — *Derivative Tables"* for further information. Non-derivative commitments, excluding commitments to acquire securities that are accounted for in accordance with EITF No. 96-11, "Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115," or EITF 96-11, discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements, are related to (1) commitments arising from mortgage swap transactions and (2) commitments to purchase single-family (2002 only) and multifamily mortgage loans that will be classified as held-for-investment under GAAP. These non-derivative commitments totaled $178.2 billion and $133.9 billion as of December 31, 2003 and 2002, respectively. Such commitments were not accounted for as derivatives in accordance with SFAS 133 and were not recorded on our consolidated balance sheets at fair value. To generate our single-family mortgage purchase volume, we individually negotiate arrangements providing for a mortgage lender's commitment to sell a high proportion of its conforming mortgage origination volume to us. We are exposed to the risk that we could lose purchase volume to the extent these agreements are terminated or modified without replacement from other lenders. We actively monitor the lenders' share volume and, if a mortgage lender fails to meet its contractual commitment, we have a variety of contractual protections, including the assessment of certain fees.

RISK MANAGEMENT

We are subject to three main business risks:

- operational risk;
- interest-rate and other market risks; and
- credit risks.

Our strategy for managing these risks is based upon the principle that risk should be understood and managed directly by the business areas, with oversight by an independent risk function and reporting to senior management and the Board of Directors, as described below. The level of our effectiveness in managing risks influences both the level and stability of our earnings and long-term value.

In October 2003, we established the Enterprise Risk Oversight group that is led by a Chief Enterprise Risk Officer currently reporting to our Chief Executive Officer. Enterprise Risk Oversight oversees our interest-rate and other market risks as well as credit risks. Prior to October 2003, these oversight responsibilities were not centralized in one group. The Operational Risk Oversight group is led by an Operational Risk Officer currently reporting to the Chief Financial Officer. On a day-to-day basis, business area risk management and line personnel manage our operational, interest rate and other market risks and credit risks. Enterprise Risk Oversight and Operational Risk Oversight provide independent oversight of these business area risk management activities. The Chief Enterprise Risk Officer and Operational Risk Officer provide advice to senior management on key risk management issues and provide independent reporting to the Audit Committee of the Board of Directors.

Operational Risk

Summary

In this discussion of our operational risk, we make numerous statements regarding our expectations relating to our assessment, evaluation and review of our internal controls and our implementation of related process improvements. Our ability to implement these improvements, however, will depend on a number of factors. See "FORWARD-LOOKING STATEMENTS" for more information.

We are subject to the risk that financial loss could result from failures or inadequacies in our operational processes. We, like most companies, are exposed to operational risk in five major areas: financial reporting, people, process, technology and external events.

We have a high level of operational risk with respect to financial reporting risk. In connection with the audit of our consolidated 2003 financial statements, PwC has identified and notified management and the Audit Committee of the existence of certain "material weaknesses" (as defined by standards established by the American Institute of Certified Public Accountants, or AICPA) in processes that support financial reporting. We have summarized the material weaknesses, each of which comprises a number of more specific issues, as follows:

- Material weaknesses in the integration of certain financial processes and systems;
- Material weaknesses in monitoring controls over certain accounting and financial operations; and
- Material weaknesses in certain documentation and change management processes.

See "*Sources of Operational Risks* — Financial Reporting Risk — *2003 Material Weaknesses in Internal Controls*" and "EXPLANATORY NOTE" for additional detail. In addition, we have a significant number of other internal control weaknesses that meet the definition of "reportable conditions" (as defined by standards established by the AICPA) related to our financial operations and reporting processes. We are still in the process of conducting a comprehensive assessment of the design of our internal controls over financial reporting and we anticipate that we will identify additional internal control weaknesses, some of which may be material weaknesses.

Previously, in connection with the audit of our financial statements for the three years ended December 31, 2002, PwC identified and notified management and the Audit Committee of the existence of certain

material weaknesses in processes that support financial reporting. We summarized the material weaknesses into the following categories:

- Corporate governance and management oversight;
- Financial accounting and reporting expertise and accountability;
- Role of Market Risk Oversight; and
- Monitoring of controls over valuation of financial instruments.

See "*Sources of Operational Risks* — Financial Reporting Risk — *2002 Material Weaknesses in Internal Controls*" for additional detail. In response to these material weaknesses, we implemented a comprehensive remediation program and, while we have more progress to make, we have substantially remediated many of the material weaknesses identified as part of the audit of our results for 2002.

Our operational risk related to financial reporting remained high in 2003, despite our remediation successes, for a number of reasons. First, while many of the issues that contributed to our 2002 material weaknesses have been either resolved or mitigated, some issues carried over into 2003. The most notable are those related to the requirement for significant systems revisions as a result of our adoption of revised accounting policies from the 2002 restatement and new accounting rules promulgated for 2003. While we have made substantial progress, we face continuing challenges because of the prior deficiencies in our accounting infrastructure and the operational complexities caused by the enormous volume of revised and new accounting policies we have adopted. Second, as we conducted in-depth reviews of our controls related to financial reporting processes, as well as our line business processes, additional material weaknesses in internal controls were identified.

Strengthening the control environment and reducing operational risk are top priorities of the company. As discussed below, we are actively addressing these material weaknesses and reportable conditions. We are finalizing plans to mitigate our material weaknesses and have reviewed our approach with the Audit Committee of the Board of Directors. These plans call for remediation or substantive mitigation before our next earnings release.

Sources of Operational Risks

Financial Reporting Risk. In 2003 and to date in 2004 our most significant operational risks have been in the area of controls over financial reporting. This area includes the risks that financial information is not produced on a timely basis or that financial information is materially misstated. We seek to mitigate these risks through internal business controls, management oversight and governance controls and appropriate staffing.

2003 Material Weaknesses in Internal Controls. PwC communicated to management and the Audit Committee that material weaknesses existed in our internal controls over financial reporting during 2003. Many are interrelated and reflect the need to redesign our accounting systems and process as well as a number of business processes in order to provide timely and accurate financial information. The material weaknesses are the result of the numerous new and revised accounting policies resulting from the restatement, new accounting rules promulgated in 2003, and an historical under-investment in infrastructure, both people and systems, to support financial reporting. We summarized the material weaknesses into the following categories:

- **Material weaknesses in the integration of certain financial processes and systems.** These material weaknesses result primarily from the lack of integration between core operating systems and accounting systems. The strain on internal controls of implementing new accounting policies is compounded by weak existing infrastructure in accounting and valuation systems. The accounting close process is labor-intensive, with certain steps that must be performed sequentially. First, preliminary results are recorded with existing systems. Second, these results are "remeasured" using interim processes, with several dependencies on manual, off-line processes to adjust to GAAP standards. In addition, valuation and accounting systems also lack integration and rely on numerous manual processes that prevent us from valuing financial instruments and verifying those values within a timeframe needed for timely financial reporting.

Material weaknesses in this category are:

- Significant integration issues among numerous core business, accounting, and external service provider operations and over-reliance on end-user systems for certain major activities.
- Inadequate controls over data input and systems limitations in financial operations.

These material weaknesses increase the risk of errors caused by hand-off failures and prevent timely detection of errors.

Though it remains a two-step process, we have implemented a number of improvements to the 2003 process, including the implementation of enhanced systems. To mitigate the risk inherent in the current two-step process we completed extensive efforts to develop appropriate controls, including significant back-end data validation and financial analytics. However, those controls prevent a timely accounting close and there continues to be a high level of inherent risk because of the operational complexities. This fact is evidenced by the immaterial errors in our previously disclosed results for 2002 that we identified and corrected in the course of the 2003 close process.

Integrated plans are being implemented to address systems and process enhancements in 2004 with longer-term efforts to significantly improve our systems and the structure of our internal controls over financial reporting. For example, we are improving the pricing process by streamlining and automating the front-end pricing and back-end verification processes to increase efficiency, scope and timeliness. We also implemented a controlled subledger system for our retained mortgage portfolio that captures all accounting data for our mortgage-related security investment activities, replacing what had been a much more manual process dependent on end-user systems.

- **Material weaknesses in monitoring controls over certain accounting and financial operations.** We rely on a variety of controls for the reliability of our financial reporting. These range from preventative controls, such as data quality screens, to detective controls, such as independent verification, reviews, or oversight. We need to strengthen certain monitoring controls in our accounting and financial operations. Weaknesses in these controls increase the risk that if errors are made, they will not be detected in a timely manner.

  Material weaknesses in this category are:

  - Inadequate staffing and systems to support the appropriate scope of independent price verification of financial instruments used in the preparation of financial statements.
  - Inadequate supervisory review of journal entries in some processes.
  - Insufficient monitoring controls within financial operations and related reporting functions.

  Resolution of our systems integration issues will address many of these weaknesses. However this is a multi-year effort. We are taking steps in the interim to substantially mitigate these weaknesses. We are also actively addressing our staffing adequacy issues. We continue to add staff and resources to the price verification process to improve its scope. We have strengthened segregation of duties and supervisory reviews of the journal entry process and further improvements are planned. We have implemented management information analysis to improve our monitoring of accounting for financial transactions. A key focus of our re-engineering effort is to design systems and processes that enable more effective monitoring and supervision. We are also undertaking internal control reviews to validate that supervisory review and monitoring controls are robust.

- **Material weaknesses in certain documentation and change management processes.** Documentation and change management controls help us evaluate whether changes in models, data, systems or processes are correct and appropriate. We have material weaknesses in certain

documentation, oversight and change management controls. See further discussion under "Technology Risk" below.

Material weaknesses in this category are:

- Technology implementation control deficiencies, including change management processes that allow access to production environments by developers.
- Access by some business end-users to production databases.
- End-user computing solutions with both insufficient documentation and change controls.
- Lack of formal change management and oversight processes over certain models used to support financial reporting.
- Insufficient documentation controls over certain data correction activities.

Change management weaknesses may result in a failure to prevent material errors in financial reporting. They also increase our reliance on manual validation procedures.

To address these weaknesses, a separate systems environment for the 2003 financial reporting processes strengthened access and change management controls and mitigated this weakness for reporting systems. We are conducting a broader review of security controls over business systems that provide data and information to financial reporting systems to fully assess this risk. Efforts are underway to document a complete inventory of all applications that support financial reporting and evaluate and institute appropriate change management controls.

We have moved the end-user systems we have currently identified as those we rely on for financial reporting to formal production environments or implemented formal change control environments for them. We have instituted numerous formal oversight and monitoring controls over models used to support financial reporting (see "*2002 Material Weaknesses in Internal Controls*"). Plans for further enhancements are underway. We are also directing significant attention to identifying and preventing data quality and input issues and reengineering the operating and financial systems to address data issues.

2002 Material Weaknesses in Internal Controls. In our 2002 Information Statement and Annual Report we noted deficiencies that PwC identified as material weaknesses. We implemented a comprehensive remediation program under the direction and oversight of the Governance Committee of the Board of Directors to address these material weaknesses and have made significant progress in reducing the severity of these weaknesses. While some of the specific issues that contributed to the material weaknesses carried over into 2003, we no longer classify the following as material weaknesses in our internal controls. We summarized the material weaknesses into the following categories:

- **Corporate governance and management oversight.** Through a variety of actions in 2003 and 2004, we have remediated issues relating to corporate governance and management oversight, including hiring a new Chief Executive Officer, President and Chief Operating Officer, Chief Financial Officer, Executive Vice President — Investments, General Counsel and General Auditor. We have filled the new positions of Chief Enterprise Risk Officer and Chief Compliance Officer, and conducted corporate-wide Code of Conduct and Sarbanes-Oxley training. We established formal policies for the review and approval of new products and for appropriate oversight of unique transactions. Finally, a review of the Board of Directors committee structure, and increased frequency of Board of Directors and committee meetings, has strengthened the corporation's governance structure.
- **Financial accounting and reporting expertise and accountability.** We have made significant progress building the staffing levels and competencies of the financial reporting staff. From January 2003 and to date in 2004, we have doubled resources within the accounting department and hired numerous senior level employees. Additional effort is needed to adequately train and manage the increased staff.

- **Role of Market Risk Oversight.** In 2003 and to date in 2004, we created a Chief Enterprise Risk Officer position reporting directly to the Chief Executive Officer. We placed the Market Risk Oversight group within the Enterprise Risk Oversight group and are actively recruiting for a senior level executive to head it. We also created a model oversight group responsible for independently assessing the design and adequacy of key models used in accounting and business decisions, including measuring interest-rate risk, credit risks and valuing financial instruments that impact the financial statements. By placing the Market Risk Oversight group within a central, independent risk function, we believe that we have strengthened our culture of independent oversight. While we are still recruiting for a head of Market Risk Oversight, we believe the severity of this weakness is reduced as this role currently is being filled by the Chief Enterprise Risk Officer.
- **Monitoring of controls over valuation of financial instruments.** In 2003 and to date in 2004 we continue to make significant improvements to the controls over valuations of financial instruments. We formalized, reviewed and documented our pricing methodologies. We created a function within our Investment and Capital Markets Division to monitor and validate the implementation of that division's pricing methods. We created an independent valuation verification group within Market Risk Oversight that uses an array of independently obtained information to evaluate the reasonableness of the valuations. Finally, we created a group reporting to the Chief Financial Officer with broad oversight of valuation processes. We also established a senior management Valuation Committee to provide strong oversight of valuation methodologies, model changes and processes for financial instruments that affect financial statements. Collectively, these changes strengthen our process to identify, review and resolve valuation issues appropriately. While not complete, we have made substantial progress on strengthening controls over our valuation processes for financial instruments. We continue to have certain deficiencies in the timeliness of valuation and the timeliness and scope of independent price verification and the formalization of management oversight and change management processes over models used to support financial statements. See "*Sources of Operational Risks* — Financial Reporting Risk — 2003 Material Weaknesses in Internal Controls."

Risk Management Strategies and Other Sources of Operational Risks

During 2003 and to date in 2004, we have significantly strengthened the number and competencies of the employees in the business areas dedicated to operational risk management. These employees seek to ensure that existing operational risk issues are identified and resolved and that new processes, systems and business activities are designed with sound operational risk and control management practices. We are also strengthening resources in the independent Enterprise Risk Oversight group, the Operational Risk Oversight group and the Internal Audit group to be able to better identify and evaluate operational risks and prioritize these risks for mitigation. Finally, we reorganized our management committees and enhanced our procedures for reporting to our Board of Directors to increase the focus on operational risk management and controls.

To improve our ability to identify and manage operational risk, we have undertaken two major corporate initiatives. First, we began implementing a new self-assessment process. We expect the new process to be fully implemented in virtually all business areas by year-end 2004. As part of the new process we defined common operational risks and standard controls, as well as business-specific controls, for each business area to use in assessing its operational risk. This implementation, and the concurrent reassessment of existing controls, has improved each business area's understanding of its operational risks and the adequacy of its controls. It has also facilitated corporate-level analysis and monitoring of key risks, controls and mitigation plans. These processes have resulted in the identification of new material control weaknesses and our assessment that internal controls remain weak.

Our second initiative is an in-depth review of internal controls over financial reporting. This review includes documentation of all current controls and an assessment by an independent reviewer of our design of internal controls. We have undertaken this internal review to assist us in:

- Identifying our control deficiencies;
- Developing remediation plans for any deficiencies; and
- Maintaining an inventory of controls to use as a basis for future effectiveness testing.

In 2004, we began identifying and monitoring key operational risk indicators and implementing processes to collect operational loss event data. We are committed to identifying and monitoring forward-looking indicators of operational risk and losses in order to improve our operations, reduce risk, and increase transparency as to the level of operational risk. These efforts are in the early stages of development and we anticipate it will be a multi-year effort to fully implement these processes.

People Risk

People risk is a significant risk for us because of the complexity of our business and the skills needed by key personnel. The capability of our people and appropriate staffing levels are critical to us. We manage this risk with recruiting, training, and retention programs. We are still making extensive use of consultants to support our remediation activities, which increases our operational risk because we are not building the capabilities of our own staff. We continue aggressive programs to recruit capable staff at both the senior management and staff levels to mitigate this risk.

Process Risk

Process risk includes transaction execution risk, model risk, and vendor management risk. Transaction execution risk is the risk arising from a failure to develop or follow appropriate internal processes for executing our business transactions. Proper transaction execution depends on quality data and internal operations. Recent focus on the prior restatement and rebuilding the systems and processes to support financial reporting has resulted in a significant strain on business processes throughout our company. We manage process risk with development and maintenance of appropriate policies, procedures and delegations, compliance monitoring, and identification and execution of control procedures such as segregation of duties and data quality standards. We have made significant investments in credit and market risk processes to soundly manage these risks and continue to strengthen these processes. We also have several initiatives underway to better understand and strengthen the process of attributing the changes in the fair values of our assets and liabilities to changes in the underlying key components and to ensure appropriate segregation of duties in our attribution analysis. We expect this attribution process to continue to improve and evolve.

Model risk is the risk that business decisions are made using model results that are incorrect or applied inappropriately. Model risk is an important area for us because of our significant use of business and financial models. We mitigate model risk by validating inputs and assumptions, model code and theory, and model outputs. Over the past year, we significantly enhanced our oversight processes, including establishing a corporate function to focus on the key models used in management decisions and financial reporting. We also continued to enhance our credit and market risk models. See "*Sources of Operational Risks* — Financial Reporting Risk — 2003 Material Weaknesses in Internal Controls" above for more information concerning internal control issues related to models.

Vendor management risk is the risk that we will suffer an operational loss, a loss of intellectual property, a breach of confidentiality, or other business harm because of our reliance on external parties to perform or assist us in performing critical business functions and processes. We currently outsource to external parties certain key functions, including processing functions for trade capture and interest-rate and other market risk management analytics reporting (Blackrock Financial Management, Inc.), processing functions for mortgage loan underwriting (Electronic Data Systems Corporation, or EDS) and back office support (Bear Stearns Securities Corporation). We may enter into similar outsourcing relationships in the same or other business areas in the future. If one or more of these key external parties were not able to perform their functions for a period of time or at an acceptable service level as determined by us, there is a risk that our financial condition

or results of operations would be adversely affected, perhaps materially. We endeavor to mitigate this risk through detailed vendor requirements, active vendor management, legal contracts, business continuity planning, monitoring, and oversight.

Technology Risk

Technology risk is the risk of financial loss caused by inadequate or failed systems, inappropriate systems implementation, or missing or inadequate system security that allows unauthorized access to computer systems.

We mitigate systems implementation and security risk by designing and implementing strong standards for development and implementation, monitoring computer security measures and applications, corporate information access policies, and periodic access reviews to verify only authorized personnel have access to our systems. We identified material weaknesses related to system security and change management during our control reviews. Remediation efforts are underway to correct these weaknesses. See also "Financial Reporting Risk" for further discussion of those issues.

External Event Risk

External event risk is the risk that a catastrophic event, such as a terrorist event, natural disaster, breach of physical security or theft, results in a significant business disruption and an inability to process transactions through normal business processes. It also includes the risk that an external party perpetrates a fraud against us that adversely affects our income or asset values.

To mitigate business disruption risk, we maintain and test a comprehensive business continuity plan and locate backup facilities for critical business processes and systems away from, although in the same metropolitan area as, our main offices. In 2004, we began a multi-year corporate effort to establish an alternate site for critical business processes that has a separate power grid, labor pool and geographic location.

To mitigate fraud risk, we rely on a variety of controls. For example, one of the most important areas of focus for us related to external fraud is the risk that our sellers or servicers knowingly misrepresent the mortgages they sell to us or service these mortgages in a manner inconsistent with our servicing guidelines. We seek to mitigate this risk through quality control reviews, on-site audits and investigations of situations involving possible fraud. See "Credit Risks" for more information.

Interest-Rate and Other Market Risks

We are exposed to the risk that changes in interest rates or in other market factors will adversely affect our cash flows, the fair value of net assets and/or future earnings. We actively manage interest-rate risk and other related market risks and take a disciplined approach to risk management. Our disciplined approach to risk management and our active deployment of capital are essential to generating fair value growth for stockholders in a wide range of interest-rate environments. Our interest-rate risk exposure results primarily from uncertainty related to the amount and timing of mortgage prepayments associated with mortgage loans and mortgage-related securities held in our Retained portfolio and the potential mismatch in the duration of our assets and liabilities. To a lesser extent, we are also exposed to interest-rate risk through our credit guarantee activities.

Our fair value of net assets represents our estimation of the fair value of our existing net assets and does not capture all elements of value that are implicit in our operations as a going concern. The fair value of our financial instruments reflects an assessment of the present value of expected future cash flows at a given point in time. To the extent that market conditions change, the expected future cash flows may differ from our estimates. As a result, estimates of our fair value of net assets may, over time, be different than our realized cash flows.

Oversight of Interest-Rate Risk and Other Market Risks

The mission of the Market Risk Oversight group is to provide independent oversight of market risk, including interest-rate risk and liquidity risk, and to enhance our market risk measurement and management capabilities so that they are consistent with industry best practice. In particular, Market Risk Oversight is responsible for providing senior management and the Board of Directors with regular, independent evaluations of whether market risks are effectively identified, measured, managed, and controlled. On a daily basis, the group monitors and reports to senior management on key risk exposure levels relative to internal operating limits. As noted previously, in 2003 we placed Market Risk Oversight within a new Enterprise Risk Oversight function, which currently reports directly to the Chief Executive Officer. The Models and Methods Oversight Group, also a part of the Enterprise Risk Oversight function, is responsible for independently assessing the design and adequacy of all key models, including prepayment models.

Sources of Interest-Rate Risk and Other Market Risks

Retained Portfolio. Our Retained portfolio activities expose us to interest-rate risk and other market risks. This exposure results primarily from the uncertainty as to when borrowers will pay the outstanding principal balance of mortgage loans and mortgage-related securities held in the Retained portfolio, known as prepayment risk, and the resulting potential mismatch in the timing of our receipt of cash flows on our assets versus the timing of our obligation to make payments on our liabilities. For the vast majority of our mortgage-related investments, the mortgage borrower has the option to make unscheduled payments of additional principal or to completely pay off a mortgage loan at any time before its scheduled maturity date (without having to pay prepayment penalties) or to hold the mortgage to its stated maturity. The borrower's option makes the timing and amount of mortgage prepayments (and thus the timing and amount of mortgage cash flows received by us) very sensitive to changes in interest rates, among other factors.

The Retained portfolio comprises mortgage investments with a range of different characteristics, including different stated maturities, underlying collateral, principal and interest payment structures and prepayment patterns. To manage the interest-rate risk associated with this wide range of mortgage-related investments, we employ a risk management strategy that seeks to substantially match the duration characteristics of our assets and liabilities. We use various instruments, including short-term debt, callable and non-callable long-term debt and derivatives, to mitigate the interest-rate risk that mortgage investments may prepay faster or slower than expected.

Types of Interest-Rate Risk and Other Market Risks. The types of interest-rate risk and other market risks that we are exposed to through our Retained portfolio are described below.

- **Duration and Convexity Risk.** The magnitude of our interest-rate risk is directly related to the net effective duration and convexity of our portfolio of assets, liabilities and derivatives. Duration is a measure of a financial instrument's price sensitivity to changes in interest rates, while convexity is a measure of how much duration itself changes as interest rates move. We actively manage duration and convexity risk through asset selection and structuring (that is, by identifying or structuring mortgage-related securities with attractive prepayment and other characteristics), by issuing a broad range of both callable and non-callable debt instruments and by transacting in both option-based and non-option-based interest-rate derivatives. To mitigate mortgage prepayment risk and therefore interest-rate risk, we maintain a high percentage of callable debt and option-based derivatives relative to the fixed-rate mortgage assets held in the Retained portfolio.

  We do not, however, hedge all prepayment option risk that exists at the time a mortgage is purchased or that arises over its life. For the portion of risk not hedged at the time of purchase, we undertake frequent rebalancing actions in order to keep our interest-rate risk exposure within management limits (see "*Interest-Rate Risk Management and Use of Derivatives* — Use of Derivatives — *Adjust Funding Mix*" below). Although duration and convexity risks have been maintained at relatively low levels as indicated by our PMVS and duration gap estimates (see "Measurement of Interest-Rate Risk — PMVS and Duration Gap"), fair value gains or losses will generally occur as market conditions change. For example, fair value gains or losses occur when our duration gap is positive or negative and the level of interest rates or shape of the yield curve changes. Similarly, because we do not hedge all of the prepayment risk inherent in our mortgage investment portfolio, fair value gains or losses occur from changes in the relationship between interest-rate volatility expected at the time a mortgage loan is acquired and the volatility actually experienced (see "Volatility Risk" below for more information).

  We monitor duration and convexity risk against limits and reporting thresholds established by senior management and the Board of Directors. Our interest-rate sensitivity is estimated and reported through our PMVS and duration gap measures. These measures are estimated on a daily basis and publicly reported on a monthly basis. See "Measurement of Interest-Rate Risk" below.

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

- **Volatility Risk.** Volatility risk is the risk that changes in the market's expectation of the magnitude of future variations in interest rates will adversely affect our cash flows, fair value of net assets and/or future earnings. The market's expectation about the future volatility of interest rates, or implied volatility, is a key determinant of the value of an interest-rate option. Higher expected volatility implies a greater likelihood that the expected life of a mortgage asset will either extend or contract. For example, higher interest-rate volatility implies a higher likelihood that interest rates will decline to levels that make mortgage prepayments attractive to homeowners, thereby making their prepayment option more valuable and making our mortgage assets subject to their prepayment option less valuable. We manage volatility risk through asset selection and by maintaining a consistently high percentage of option-embedded liabilities (*e.g.*, callable debt) and option-based derivatives relative to our mortgage assets. We monitor volatility risk by measuring exposure levels on a daily basis and we maintain internal limits on the amount of volatility risk exposure. See "Duration and Convexity Risk" above for further discussion of implied and realized volatility.

- **Basis Risk.** Basis risk is the risk that interest rates in different market sectors will not move in tandem and will adversely affect our cash flows, fair value of net assets and/or future earnings. This risk arises principally because we fund and hedge mortgage-related investments with agency

debt and LIBOR and Treasury-based interest-rate derivatives. The basis risk arising from funding Retained portfolio investments with agency debt, which we do not actively manage, is discussed below in "Mortgage-to-Debt Spread Risk." We also incur basis risk when we use LIBOR or Treasury-based instruments in our risk management activities. We monitor the fair value fluctuations associated with these basis risks and manage this exposure by adjusting our mix of LIBOR and Treasury-based instruments and our debt in response to changes in the expected interest-rate relationships in these different markets. We monitor basis risk on a daily basis and maintain internal limits on the amount of basis risk exposure.

- **Prepayment Model Risk.** Prepayment model risk is the risk that actual mortgage prepayment behavior will differ from the prepayment behaviors we forecast using our proprietary internal models and will adversely affect our cash flows, fair value of net assets and/or future earnings. These models are used to determine the estimated duration and convexity of mortgage assets for PMVS and duration gap measures. To mitigate prepayment model risk, we perform extensive monthly back testing of actual results against model results and sensitivity analysis to facilitate informed asset selection and risk management decisions. However, expected returns can be affected by differences between prepayments forecasted by the models and actual prepayments.

- **Mortgage-to-Debt Option-Adjusted Spread Risk.** Mortgage-to-debt option-adjusted spread risk is the risk that an increase in the spread between the interest rate on mortgage assets and debt used to finance these investments will, in the short term, adversely affect our cash flows, fair value of net assets and/or future earnings. Mortgage-to-debt option-adjusted spread risk is inherent to any mortgage investor that uses debt to finance mortgage purchases, as is the case with our Retained portfolio and those of other large mortgage investors.

  We consider mortgage-to-debt option-adjusted spread risk in our asset purchase activities by establishing thresholds for expected return on equity for new asset purchases. Once mortgage assets have been purchased for the Retained portfolio, we generally hold a substantial portion of these assets for the long-term, with an objective of realizing the expected initial return on equity on those assets over this time frame. Therefore, we do not take actions attempting to manage or hedge period-to-period fluctuations in the fair value of the existing Retained portfolio resulting from changes in mortgage-to-debt option-adjusted spreads. We do not believe such fluctuations will significantly affect the long-term return on our existing Retained portfolio.

- **Foreign Currency Risk.** Foreign currency risk is the risk that fluctuations in currency exchange rates (*e.g.*, foreign currencies to the U.S. dollar) will adversely affect our cash flows, fair value of net assets and/or future earnings. Our exposure to foreign currency risk arises primarily because we issue debt denominated in currencies other than the U.S. dollar, our functional currency. In the case of our €Reference Notes® securities program, we are obligated to make periodic interest and principal payments in Euros. We mitigate the risk associated with fluctuations in currency exchange rates by entering into swap transactions that effectively convert foreign-denominated obligations into U.S. dollar denominated obligations. The exchange rate risk is completely hedged when the debt's principal and the swap's notional amounts and the timing of the payments are identical. In some market conditions, we use short-term currency hedges until permanent hedges are secured. Our exposure to foreign-currency risk is minimal because only a small percentage of our debt is denominated in foreign currencies (approximately 4 percent as of December 31, 2003) and because the vast majority of the currency-risk exposure arising from debt issuances is eliminated when hedges are established for the debt's entire expected maturity. Foreign currency swaps also expose us to institutional credit risk, which we discuss under "Credit Risks — *Institutional Credit Risk*."

Credit Guarantee Activities. The fair value of the existing credit guarantee portfolio fluctuates with changes in interest rates and credit expectations. We do not hedge changes in the fair value of our existing credit guarantee portfolio, other than the interest-rate exposure related to net buy-ups (upfront payments made by us which increase the guarantee fee that we will receive in connection with our PC guarantee). We also hedge expected gains (losses) resulting from our mortgage security program cycles. Timing differences

caused by mortgage security program cycles can lead to significant interest expense, particularly in a rapidly declining interest-rate environment. If the interest rate paid to a PC investor is higher than the reinvestment rate on payments received from mortgage borrowers, we bear the cost difference, recognized as interest expense, for the time period between when the borrower pays us and when we reduce the PC balance.

While year-to-year changes in the fair value of the guarantee portfolio may have a significant impact on the fair value of net assets, we believe that changes in the fair value of our existing guarantee portfolio are not a good indication of long-term fair value expectations because such changes do not reflect the strong probability that over time replacement business will largely replenish guarantee fee income lost because of prepayments.

Interest-Rate Risk Management and Use of Derivatives

Our disciplined approach to interest-rate risk management utilizes a variety of asset and liability related strategies that frequently involve the use of derivative transactions. The primary ways in which we use derivatives to manage interest-rate risk are discussed below under "Use of Derivatives." Our management of interest-rate risk also involves asset-related strategies through which we seek to invest in mortgage assets that are less sensitive to prepayment risk. These strategies include the creation of Structured Securities from assets held in our Retained portfolio, the sale of some of these securities, and the retention of those classes that are expected to optimize our risk or return profile.

Interest-rate risk management activities can significantly affect the level and timing of our net income due to a variety of factors. These factors include the amount of prepayment risk hedged at the time mortgage assets are purchased versus the amount hedged over time through rebalancing actions, the risk tolerances that management deems advisable at various times and changes in the cost of rebalancing transactions. Although risk management activities may be highly effective when viewed from an economic perspective, they may contribute to volatility in earnings under GAAP, particularly when derivatives are not in qualifying hedge accounting relationships.

Summary of Derivative Positions. The net fair value of our derivatives was a net asset balance of $15,823 million and $9,426 million at December 31, 2003 and December 31, 2002, respectively. This includes certain commitments to purchase and sell mortgage loans, mortgage-related securities and agency debt that we treat as derivatives. See "Types of Derivatives — *Forward Purchase and Sale Commitments*" for more information. In our consolidated balance sheets, derivative instruments are presented in Derivative assets, at fair value and Derivative liabilities, at fair value. Table 44 summarizes our derivative positions at December 31, 2003 and December 31, 2002.

Table 44 — Total Derivative Portfolio

	December 31,			
	2003		2002	
	Notional Balance	Net Asset (Liability) at Fair Value(1)	Notional Balance	Net Asset (Liability) at Fair Value(1)
	(dollars in millions)			
Interest-rate derivatives(2)	$ 978,778	$16,048	$ 969,080	$9,169
Commitments(3)	89,320	(230)	191,563	253
Subtotal	1,068,098	15,818	1,160,643	9,422
Credit Derivatives(4)	15,542	5	17,301	4
Total	$1,083,640	$15,823	$1,177,944	$9,426

(1) The fair values of derivatives (netted by counterparty as permitted under GAAP) are presented as Derivative assets, at fair value and Derivative liabilities, at fair value on our consolidated balance sheets. Collateral was held on approximately 95 percent and 90 percent of the exposure to derivative counterparty risk for over-the-counter, or OTC, derivative agreements for interest-rate swaps, option-based derivatives and foreign currency swaps as of December 31, 2003 and 2002, respectively. See "Table 45 — Derivative Counterparty Credit Exposure" for more information about our derivative counterparty credit exposure.
(2) Includes a prepayment management agreement entered into during 2002. See "Types of Derivatives" for more information concerning the nature of the prepayment management agreement.
(3) Consists of commitments to purchase and sell mortgage loans, mortgage-related securities and various debt securities that are subject to the requirements of SFAS 133 and accordingly must be recorded at fair value on the consolidated balance sheets.
(4) Consists of certain credit risk-sharing agreements that are subject to the requirements of SFAS 133 and accordingly must be recorded at fair value on the consolidated balance sheets. See "Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for more information.

Types of Derivatives. We use derivatives that are common in the financial markets to conduct our risk management activities. Substantially all of our derivative positions fall into the following four categories (see "Table 46 — Summary of the Effect of Derivatives on Selected Consolidated Financial Statement Captions" for notional balances for each of these derivative types):

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

In addition to swaps, futures and options, our derivative positions include certain purchase and sale commitments and other contractual agreements, including credit risk-sharing agreements, as noted above, and discussed further below.

Forward Purchase and Sale Commitments. We routinely enter into forward purchase and sale commitments for mortgage loans, mortgage-related securities and agency debt. Some of these commitments are subject to the requirements of SFAS 133 and accordingly must be recorded at fair value on our consolidated balance sheets.

Prepayment Management Agreement. Practices of seller/servicers may affect prepayment levels on mortgages that underlie PCs. As a result, mortgages underlying some PCs may be prepaid faster than similar mortgages underlying other PCs, adversely affecting our management and guarantee income and the performance of our mortgage-related securities. We have taken steps to achieve our corporate objective that prepayment experience on PCs be consistent with market norms. Beginning in 2002, we required that certain mortgage pools we considered to pose elevated risk of prepayment be covered by a prepayment management agreement to partially compensate us for the adverse financial impacts caused by disproportionately higher mortgage prepayments. We have also offered an incentive through an adjusted guarantee fee level on future mortgage deliveries when the prepayment experience of the mortgage pools is within defined ranges. This type of agreement is accounted for as a derivative in accordance with SFAS 133 and classified as no hedge designation with changes in fair value recorded as Derivative gains (losses) on the consolidated statements of income. This type of agreement is reflected at fair value on our consolidated balance sheets in the Derivative asset or Derivative liability caption. At December 31, 2003 and 2002, approximately $152.5 billion and $117.2 billion, respectively, of the mortgages underlying PCs included in our total mortgage portfolio (see

"Table 1 — Freddie Mac's Total Mortgage Portfolio Based on Unpaid Principal Balances") were subject to this type of agreement. Amounts due to us under this type of agreement were reported as a component of our management and guarantee income.

Use of Derivatives. To manage interest-rate and other market risks, we use derivatives primarily to:

- Hedge forecasted issuances of debt and synthetically create callable and non-callable funding;
- Hedge foreign-currency exposure associated with certain debt issuances; and
- Regularly adjust or rebalance our funding mix in order to more closely match changes in the interest-rate characteristics of our mortgage assets.

Hedge Forecasted Debt Issuances and Create Synthetic Funding. We typically commit to purchase mortgage investments on an opportunistic basis for a future settlement date that often ranges from two weeks to three months after the date of the commitment. To facilitate larger and more predictable debt issuances that contribute to lower funding costs, we use interest-rate derivatives to hedge the anticipated debt issuances associated with these periodic mortgage purchases. In doing so, we hedge the interest-rate risk exposure, from an economic perspective, from the time the mortgage is committed to be purchased to the time the debt is issued. We typically fund mortgage investments with a combination of callable and non-callable debt of various maturities in order to better match the cash flow and optionality characteristics of the mortgage investments. Through the use of interest-rate derivatives, we can synthetically create the substantive economic equivalent of these various funding structures. For example, the combination of a series of short-term debt issuances over a defined longer-term period and a pay-fixed swap with the same maturity is the substantive economic equivalent of a long-term debt instrument of comparable maturity. Similarly, the combination of non-callable debt and a swaption, or option to enter into a receive-fixed swap with the same maturity as the non-callable debt is the substantive economic equivalent of callable debt. The ability to either issue debt or synthetically create the substantive economic equivalent through derivatives increases funding flexibility, allows us to better match asset and liability cash flows and often reduces the overall funding cost.

Hedge Foreign-Currency Exposure. On a less frequent basis, we also use derivatives to hedge foreign currency exposure associated with foreign currency denominated debt issuances, such as our €Reference Notes® securities program, as discussed above in "*Sources of Interest-Rate Risk and Other Market Risks —* Retained portfolio — Foreign-Currency Risk." Through the use of derivatives, we are able to mitigate nearly all currency risk at the time of debt issuance.

Adjust Funding Mix. As market conditions dictate, we undertake rebalancing actions in order to keep our interest-rate risk exposure within management limits. As interest rates decline, mortgage prepayments tend to increase and the expected life of mortgages tends to decrease. In this environment, we typically enter into receive-fixed swaps or purchase Treasury-based derivatives to adjust the duration of our funding to offset the declining mortgage duration. As interest rates increase, prepayments tend to decrease and lengthen the expected life of mortgages. In this case, we typically enter into pay-fixed swaps or sell Treasury-based derivatives in order to adjust the duration of our funding to offset increasing mortgage duration.

Derivative-Related Risks

Our use of derivatives exposes us to derivative market liquidity risk and counterparty credit risk. We are subject to derivative market liquidity risk, described below, arising from possible difficulties in entering into derivatives to meet our needs. Credit risk arises from the possibility that the counterparty will not be able to deliver the amount owed.

Derivative Market Liquidity Risk. Derivative market liquidity risk refers to the risk that we may not be able to enter into derivative transactions at a reasonable cost. A lack of sufficient capacity or liquidity in the derivatives market could limit our risk management activities, increasing our exposure to interest-rate risk. Limited liquidity or capacity in the derivatives market could make derivatives that we need for risk management purposes either unavailable or prohibitively expensive. To provide continuous access to derivative markets, we use a variety of products and transact with many different derivative counterparties. In addition to

OTC derivatives, we also use exchange-traded derivatives, asset securitization activities, callable debt, and short-term debt to rebalance our portfolio.

To mitigate the risk that we may be unable to enter into replacement derivatives transactions at reasonable cost, we limit our duration and convexity exposure to each counterparty. At December 31, 2003, the largest single notional balance of our 27 OTC counterparties listed in "Table 45 — Derivative Counterparty Credit Exposure" was $76,342 million or 11 percent of total notional balances of our OTC interest-rate swaps, option-based derivatives and foreign currency swaps.

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

We actively manage our exposure to counterparty credit risk. We use several tools to manage and minimize counterparty credit risk including:

- Review of external rating analyses;
- Strict standards for approving new derivative counterparties;
- Ongoing monitoring of our positions with each counterparty by type of derivative;
- Diversification of counterparties (discussed under "Derivative Market Liquidity Risk");
- Master netting agreements and collateral agreements; and
- Stress-testing to evaluate potential exposure under possible adverse market scenarios.

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

Derivative Counterparties. Our standards for entering into OTC interest-rate swaps, option-based derivatives and foreign-currency swaps include 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. For example, if we have a gain position on one derivative and a loss position on another derivative with the same counterparty, then the gain can be netted with the loss to determine the amount of our net exposure to the counterparty. 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 posting thresholds. Our collateral agreements require most counterparties to post collateral for the amount of our net exposure to them. Derivative exposures and collateral amounts are monitored on a daily basis using both internal pricing models and dealer price quotes. Our derivative counterparties typically transfer collateral within one to three business days based on the values of the related derivatives. As described further below, this time lag in posting collateral can affect our net uncollateralized exposure to derivative counterparties.

The collateral posted by counterparties serves to protect us against the risk of counterparty credit losses. Collateral posted by a derivative counterparty is typically in the form of cash, U.S. Treasury securities, agency securities or other mortgage-related securities. In the event a counterparty defaults on its obligations under the derivatives agreement and the default is not remedied in the manner prescribed in the agreement, we have the right under the agreement to direct the custodian bank to transfer the collateral to us or, in the case of non-cash collateral, to sell the collateral and transfer the proceeds to us.

Table 45 summarizes our exposure to counterparty credit risk in our derivatives. This table is useful in understanding our credit risk related to our derivative portfolio.

Table 45 — Derivative Counterparty Credit Exposure

	December 31, 2003					
Rating[(1)]	Number of Counterparties[(2)]	Notional	Total Exposure at Fair Value[(3)]	Exposure, Net of Collateral[(4)]	Weighted Avg. Contractual Maturity (in years)	Collateral Posting Threshold[(5)]
		(dollars in millions)				
AAA	2	$ 2,825	$ 283	$283	3.6	Mutually agreed upon
AA+	1	604	303	5	24.7	$10 million or less
AA	4	119,409	1,610	29	4.6	$10 million or less
AA−	7	237,048	7,091	250	4.1	$10 million or less
A+	6	236,944	5,922	133	5.4	$1 million or less
A	3	87,001	2,143	95	5.2	$1 million or less
A−	4	1,018	19	1	3.3	$1 million or less
Subtotal[(6)]	27	684,849	17,371	796	4.8	
Other derivatives[(7)]		141,381	—	—		
Prepayment management agreement[(8)]		152,548	—	—		
Commitments[(9)]		89,320	101	101		
Credit derivatives[(10)]		15,542	7	7		
Total derivatives		$1,083,640	$17,479	$904		

	December 31, 2002					
Rating[(1)]	Number of Counterparties[(2)]	Notional	Total Exposure at Fair Value[(3)]	Exposure, Net of Collateral[(4)]	Weighted Avg. Contractual Maturity (in years)	Collateral Posting Threshold[(5)]
		(dollars in millions)				
AAA	2	$ 2,438	$ 386	$ 386	4.4	Mutually agreed upon
AA+	1	609	299	13	25.5	$10 million or less
AA	3	97,229	1,161	104	4.3	$10 million or less
AA−	9	205,769	3,764	307	4.9	$10 million or less
A+	8	214,833	2,922	183	4.6	$1 million or less
A	2	83,776	1,559	48	3.7	$1 million or less
A−	2	1,655	21	3	1.8	$1 million or less
Subtotal[(6)]	27	606,309	10,112	1,044	4.5	
Other derivatives[(7)]		245,552	—	—		
Prepayment management agreement[(8)]		117,219	—	—		
Commitments[(9)]		191,563	1,283	1,283		
Credit derivatives[(10)]		17,301	4	4		
Total derivatives		$1,177,944	$11,399	$2,331		

(1) We use the lower of S&P and Moody's ratings to manage collateral requirements. In this table, the rating of the legal entity (or the guarantor of the legal entity) is stated in terms of the S&P equivalent.
(2) Based on legal entities. Affiliated legal entities are reported separately.
(3) For each counterparty, this amount includes derivatives with a net positive fair value (recorded as Derivative assets, at fair value and Derivative liabilities, at fair value) including the related accrued interest receivable/payable (net) (recorded in Accounts and other receivables, net and Accrued interest payable).
(4) Total Exposure at Fair Value less collateral held as determined at the counterparty level.
(5) Counterparties are required to post collateral when their exposure exceeds agreed-upon collateral posting thresholds. These thresholds are typically based on the counterparty's credit rating and are individually negotiated.
(6) Consists of OTC derivative agreements for interest-rate swaps, option-based derivatives and foreign-currency swaps.
(7) Consists primarily of exchange-traded contracts. Exchange-traded derivatives do not measurably increase our exposure to counterparty credit risk because changes in value of open exchange-traded contracts are settled daily through a financial clearinghouse established by each exchange.
(8) Represents an OTC derivative agreement. See "Interest-Rate Risk Management and Use of Derivatives" for additional information concerning the nature of the prepayment management agreement.
(9) Consists of OTC derivative agreements for forward purchase and sale commitments.
(10) Represents OTC derivative agreements. See "Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for additional information about credit derivatives.

Over time, our exposure to certain counterparties for OTC interest-rate swaps, option-based derivatives and foreign currency swaps varies depending on changes in period-end interest rates, the implied volatility of interest rates, foreign-currency exchange rates and the amount of derivatives held. Our uncollateralized exposure to counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, after applying netting agreements and collateral, decreased to $796 million as of December 31, 2003 from $1,044 million as of December 31, 2002. This decrease in uncollateralized exposure was due to the following four factors:

- A significant decrease in uncollateralized exposure to AAA-rated counterparties, which typically are not required to post collateral given their low risk profile;
- Decreases in the differences between fair value estimates used by our derivative counterparties in determining the value of collateral to be posted and the estimates of derivative fair values used in our financial reporting;
- Market movements during the time period between when a derivative is marked to fair value and the date we receive the related collateral. Our derivative counterparties typically post collateral one to three business days after we request collateral; and
- Decreases in the exposure below the posting thresholds of our derivative counterparties.

As indicated in Table 45, approximately 95 percent of our counterparty credit exposure for these OTC derivatives was collateralized at December 31, 2003. In the extremely unlikely event that all of our OTC derivative counterparties for interest-rate swaps, option-based derivatives and foreign currency swaps were to have defaulted simultaneously on December 31, 2003, our maximum loss for accounting purposes would have been approximately $796 million. As discussed below, in *"Derivative Portfolio Stress Testing,"* however, our economic loss, as measured by our potential additional uncollateralized exposure, may be higher than the $796 million uncollateralized exposure of our derivatives if we were not able to replace the defaulted derivatives in a timely fashion.

OTC Forward Purchase and Sale Commitments Treated as Derivatives. Since the typical maturity for our OTC commitments is less than one year, we do not require master netting and collateral agreements for the counterparties of these commitments. Therefore, as indicated in Table 45, the exposure to OTC commitments counterparties of $101 million and $1,283 million as of December 31, 2003 and 2002, respectively, was uncollateralized. The decrease in uncollateralized exposure was due to the following two factors:

- A significant decrease in the volume of unsettled commitments as of December 31, 2003 which contributed to the reduction of notional amounts for OTC commitments treated as derivatives; and
- A decrease in interest rates from December 31, 2002 to December 31, 2003, which contributed to a decrease in positive fair value for these commitments since we were in a net forward sale position with these commitments.

Similar to counterparties for 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.

Derivative Portfolio Stress-Testing. Market values of derivatives can change significantly when market conditions change. As a result, we monitor the risk that our uncollateralized exposure to each of our OTC counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps will increase under certain adverse market conditions. We regularly perform severe market stress tests to evaluate the potential additional uncollateralized exposure we have to each of these derivative counterparties. The market stress test assumes changes in the level, slope and implied volatility of interest rates and changes in foreign-currency exchange rates over a brief time period. The market stress test also assumes conservative OTC counterparty default rates coupled with low recovery rates to calculate our potential exposure to each OTC counterparty.

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

Derivative Tables

Table 46 shows the notional amount for each of our hedge accounting categories under SFAS 133 and the corresponding impact of those positions on our consolidated financial statements. The application and effectiveness of our hedging strategies can materially affect stockholders' equity and the timing of our recognition of earnings. As Table 46 shows, a significant portion of our derivatives was not designated in hedge accounting relationships at December 31, 2003 and 2002. See "NOTE 12: DERIVATIVES" to the consolidated financial statements for more information concerning our hedging activity.

Table 46 — Summary of the Effect of Derivatives on Selected Consolidated Financial Statement Captions

Description	Consolidated Balance Sheets					
	December 31, 2003			December 31, 2002		
	Notional Amount	Fair Value (Pre-Tax)[1]	AOCI[2] (Net of Tax)	Notional Amount	Fair Value (Pre-Tax)[1]	AOCI[2] (Net of Tax)
	(dollars in millions)					
Fair value hedges	$ 145,690	$10,185	$ —	$ 144,665	$ 9,032	$ —
Cash flow hedges	141,903	(2,808)	(1,927)	119,999	(8,421)	(5,465)
No hedge designation[3][4]	796,047	8,446	—	913,280	8,815	—
Subtotal of existing derivative positions[2]	1,083,640	15,823	(1,927)	1,177,944	9,426	(5,465)
Balance related to closed cash flow hedges[2]	—	—	(5,910)	—	—	(4,412)
Total	$1,083,640	$15,823	$(7,837)	$1,177,944	$ 9,426	$(9,877)

Description	Consolidated Statements of Income					
	Year Ended December 31, 2003		Year Ended December 31, 2002		Year Ended December 31, 2001	
	Hedge Accounting Gains (Losses)[5]	Derivative Gains (Losses)[6][7]	Hedge Accounting Gains (Losses)[5]	Derivative Gains (Losses)[6][7][8]	Hedge Accounting Gains (Losses)[5]	Derivative Gains (Losses)[6][7][8]
	(dollars in millions)					
Fair value hedges	$697	$—	$241	$ —	$(280)	$ —
Cash flow hedges	(53)	29	(54)	116	(14)	46
No hedge designation[3][4]	—	10	—	5,186	—	(2,359)
Total	$644	$39	$187	$5,302	$(294)	$(2,313)

(1) The fair values of derivatives (netted by counterparty as permitted by GAAP) are presented as Derivative assets, at fair value and Derivative liabilities, at fair value on our consolidated balance sheets. The fair values for futures are directly derived from quoted market prices. Fair values of other derivatives are derived primarily from valuation models with incorporation of market-based inputs.

(2) Derivatives that meet specific criteria are accounted for as cash flow hedges under SFAS 133. Changes in the effective portion of the fair value of these open derivatives contracts are recorded in AOCI, net of taxes. Net deferred gains and losses on closed cash flow hedges (*i.e.*, where the derivative is either terminated or redesignated) are also classified in AOCI, net of taxes, until the related forecasted transaction is determined to be probable of not occurring or affects earnings.

(3) A significant portion of our derivatives is not designated in hedge accounting relationships and is reported as no hedge designation. For most derivatives not qualifying as an accounting hedge, fair value gains and losses are reported as Derivative gains (losses) on our consolidated statements of income. For purchase and sale commitments of securities classified as trading under SFAS 115, (with notional balances of approximately $78 billion, $147 billion and $85 billion at December 31, 2003, 2002 and 2001, respectively), fair value gains and losses are reported as Gains (losses) in investment activity on our consolidated statements of income and therefore, those fair value gains and losses are not included above.

(4) Includes credit derivatives. See "Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for more information.

(5) Hedge accounting gains (losses) arise when the fair value change of a derivative does not exactly offset the fair value change of the hedged item. For further information, See "NOTE 12: DERIVATIVES" to the consolidated financial statements.

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

(7) In accordance with interpretive guidance published by the Office of the Chief Accountant of the SEC, we reclassified the periodic cash settlements in accordance with the contractual terms of derivatives not designated in a hedging relationship from Income (expense) related to derivatives, a component of Net interest income, to Derivative gains (losses), a component of Non-interest income, for all periods presented. These reclassifications, which decreased Derivative gains (losses) and increased Income (expense) related to derivatives, totaled $639 million and $456 million on a full year basis for 2002 and 2001, respectively.

(8) Subsequent to the issuance of our Information Statement dated February 27, 2004, we revised the Derivative gains (losses) reported for Cash flow hedges and No hedge designation for the years ended December 31, 2002 and 2001. The effect of this change was an increase to Derivative gains (losses) reported for Cash flow hedges and a decrease to Derivative gains (losses) reported for No hedge designation of $13 million and $4 million for 2002 and 2001, respectively.

Effect on Consolidated Financial Statements. The funding strategy of hedging the variability of cash flows from forecasted issuances of debt with various derivatives is defined as a cash flow hedge under SFAS 133. To qualify for cash flow hedge accounting treatment, hedged forecasted transactions must be considered probable of occurring. In addition, SFAS 133 imposes a variety of operational requirements that must be met. At December 31, 2003, $141.9 billion notional amount of derivative contracts was designated in

cash flow hedge relationships, including $132.0 billion notional amount of pay-fixed swaps, $1.5 billion notional amount of foreign-currency swaps and $8.4 billion notional amount of commitments. The current fair value of the derivatives included in cash flow hedge relationships is recorded on the consolidated balance sheet as Derivative assets, at fair value or Derivative liabilities, at fair value. For derivatives that receive cash flow hedge accounting treatment under SFAS 133, the effective portion of the change in fair value of the derivative asset or derivative liability is presented in the stockholders' equity section of our consolidated balance sheets in AOCI, net of taxes. The effective portion of the derivative generally offsets, on a cumulative basis, the cumulative change in the present value of the hedged cash flows.

As of December 31, 2003, the net cumulative change in the fair value of all derivatives designated in cash flow hedge relationships that were still open or for which the forecasted transactions had not occurred since SFAS 133 was implemented on January 1, 2001 (net of amounts previously reclassified to earnings through December 31, 2003) was a loss of approximately $7.8 billion on an after-tax basis. This amount was recorded in AOCI, net of taxes as described above and in Table 46.

The $7.8 billion in hedging losses related to cash flow hedges was composed of approximately $1.9 billion in net unrealized derivatives losses on open hedges and approximately $5.9 billion in deferred derivatives net losses on closed hedges. The $1.9 billion in unrealized fair value losses on existing cash flow hedges can change substantially due to future changes in interest rates. For example, a decrease in LIBOR generally will increase the amount of unrealized losses for pay-fixed swaps recorded in AOCI, net of taxes. An increase in LIBOR generally will decrease unrealized losses or create an unrealized gain to be recorded in AOCI, net of taxes, depending on the magnitude of the rate movement. The increase in unrealized fair value losses on open hedges involving pay-fixed swaps recorded in AOCI, net of taxes generally should be offset by a reduction in future borrowing costs on related forecasted debt issuances. Conversely, decreases in unrealized losses on pay-fixed swaps generally should be offset by a comparable increase in future borrowing costs.

The remaining portion of the $7.8 billion in hedging losses recorded in AOCI, net of taxes at December 31, 2003 related to $5.9 billion of deferred losses on closed cash flow hedge relationships. Closed cash flow hedges involve derivatives that have been terminated or are no longer designated in cash flow hedge relationships. Fluctuations in prevailing market interest rates have no impact on the deferred portion of AOCI, net of taxes relating to losses on terminated cash flow hedges. Therefore, the $5.9 billion in deferred losses will be recognized as a reduction of earnings as the originally hedged forecasted transactions affect earnings unless it becomes probable that the forecasted transaction will not occur. If it is probable that the forecasted transaction will not occur, then the entire deferred amount associated with the forecasted transaction will be reclassified into earnings immediately.

Assuming no changes in interest rates or other factors affecting derivative valuations, we estimate that approximately $2.5 billion (net of taxes) of the $7.8 billion of hedging losses (of which $5.9 billion is deferred and $1.9 billion are unrealized losses) in AOCI, net of taxes, at December 31, 2003 will be reclassified into earnings in the year ended December 31, 2004. The balance in AOCI, net of taxes, related to unrealized losses is affected by the accrual of periodic cash settlements in accordance with the contractual terms of derivatives in qualifying cash flow hedge accounting relationships, as well as changes in interest rates.

Table 47 summarizes the notional amounts for each type of derivative, including our new contracts, maturities and terminations during the year. This information indicates the level and type of derivative activity undertaken by us during the year and reflects our use of different derivative products in the execution of our risk management strategies. The notional amounts of our derivatives are a reference point for counterparties to determine the payments owed between us and our counterparties under the contract. The notional amount of a derivative is not an indication of the fair value of the position or of the cash flows related to the position. In most market environments, derivatives have fair values that are a small percentage of their notional amount.

Table 47 — Changes in Derivative Notional or Contractual Amounts

	Year Ended December 31, 2003			
	Derivative Notional or Contractual Amount[1]			
	Beginning Balance	New Contracts	Maturities/ Terminations	Ending Balance
	(dollars in millions)			
Interest-rate swaps				
Pay-fixed	$135,758	$ 228,727	$ (184,734)	$ 179,751
Receive-fixed	149,397	162,363	(204,343)	107,417
Basis (floating to floating)	4,941	136	(4,653)	424
Option-based	289,667	245,010	(173,349)	361,328
Futures	228,411	444,830	(542,443)	130,798
Foreign-currency swaps	43,687	23,193	(20,368)	46,512
Subtotal	$851,861	$1,104,259	$(1,129,890)	826,230
Prepayment management agreement[2]				152,548
Commitments				89,320
Credit derivatives[3]				15,542
Total				$1,083,640

	Year Ended December 31, 2002			
	Derivative Notional or Contractual Amount[1]			
	Beginning Balance	New Contracts	Maturities/ Terminations	Ending Balance
	(dollars in millions)			
Interest-rate swaps				
Pay-fixed	$ 250,461	$ 60,381	$ (175,084)	$ 135,758
Receive-fixed	186,957	136,360	(173,920)	149,397
Basis (floating to floating)	5,353	10,338	(10,750)	4,941
Option-based	408,453	195,927	(314,713)	289,667
Futures	162,987	680,174	(614,750)	228,411
Foreign-currency swaps	23,995	28,698	(9,006)	43,687
Subtotal	$1,038,206	$1,111,878	$(1,298,223)	851,861
Prepayment management agreement[2]				117,219
Commitments				191,563
Credit derivatives[3]				17,301
Total				$1,177,944

(1) Notional or contractual amounts are used to calculate the periodic amounts to be received and paid and generally do not represent actual amounts to be exchanged or directly reflect our exposure to institutional credit risk. Notional or contractual amounts are not recorded as assets or liabilities in our consolidated balance sheets.
(2) See "*Interest-Rate Risk Management and Use of Derivatives* — Types of Derivatives" for additional information concerning the prepayment management agreement.
(3) See "Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for additional information on credit derivatives.

The total notional amount of our derivatives (excluding the prepayment management agreement, commitments and credit derivatives) decreased by $25.6 billion from December 31, 2002 to December 31, 2003. This decrease in notional amount was due primarily to the net effect of the following two factors:

- A reduction in our use of futures; and
- An increase in our use of option-based derivatives.

Table 48 summarizes the change in derivative fair values for the periods presented. See "Table 49 — Derivative Fair Values and Maturities" for a breakdown of our derivatives fair value by derivative type. Also see "CRITICAL ACCOUNTING POLICIES — Fair Value" for a discussion of how changes in fair values affect our financial results under GAAP. Further detail on derivative assets, which represent our exposure to our derivative counterparties, is provided in "Table 45 — Derivative Counterparty Credit Exposure."

Table 48 — Changes in Derivative Fair Values

	Year Ended December 31,	
	2003	**2002**
	(dollars in millions)	
Beginning balance — Net asset (liability)	$ 9,426	$ (648)
Net change in:		
Exchange-traded derivatives[1]	(609)	701
Commitments	(483)	364
Credit derivatives[2]	1	4
Other derivatives:[3]		
Changes in fair value[4]	6,572	5,051
Fair value of new contracts entered into during the period[5]	4,841	2,390
Contracts realized or otherwise settled during the period[4]	(3,925)	1,564
Ending balance — Net asset (liability)	$15,823	$9,426

(1) The fair value changes for exchange-traded derivatives are determined by the individual exchanges and not by us.
(2) See "Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for additional information on credit derivatives.
(3) Includes fair value changes for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps.
(4) Subsequent to the issuance of our 2002 Information Statement dated February 27, 2004, we revised the amounts reported for the year ended December 31, 2002 to present the effect of certain foreign-currency translation gains associated with terminated or matured foreign-currency swaps. This revision resulted in a $229 million increase to the caption Changes in fair value and an equivalent decrease to the caption Contracts realized or otherwise settled during the period. Accordingly, the ending balance was not affected by this change.
(5) Consists primarily of cash premiums paid or received on options and the initial value of interest-rate swaps after we have exercised related swaptions.

Table 49 shows the notional amount and fair value for each derivative type and the maturity profile of the positions. The fair values of the derivative positions are presented on a product-by-product basis, without netting by counterparty. This information is useful in understanding how the fair values have changed over time. The fair value of a longer-term derivative generally will vary more over time than a comparable derivative with a shorter maturity. A positive fair value in Table 49 for a derivative product category is the estimated amount, prior to netting by counterparty, that we would be entitled to receive if we terminated those transactions. A negative fair value is the estimated amount, prior to netting by counterparty, that we would owe if we terminated the derivatives in that product category.

Table 49 — Derivative Fair Values and Maturities

	As of December 31, 2003					
			Fair Value[3]			
	Notional Amount[1]	Total Fair Value[2]	Less than 1 year	1 to 3 Years	Greater than 3 and up to 5 Years	In excess of 5 years
	(dollars in millions)					
Interest-rate swaps						
Pay-fixed	$ 179,751	$(3,821)	$ (51)	$ (423)	$ (118)	$(3,229)
Receive-fixed	107,417	1,992	32	459	180	1,321
Basis (floating to floating)	424	2	4	(2)	—	—
Option-based	361,328	9,294	1,762	4,249	1,553	1,730
Futures	130,798	181	177	4	—	—
Foreign-currency swaps	46,512	8,400	1,848	2,889	855	2,808
Prepayment management agreement[4]	152,548	—	—	—	—	—
Commitments	89,320	(230)	(230)	—	—	—
Subtotal	1,068,098	15,818	$3,542	$7,176	$2,470	$ 2,630
Credit derivatives[5]	15,542	5				
Total	$1,083,640	$15,823				

	As of December 31, 2002					
			Fair Value[3]			
	Notional Amount[1]	Total Fair Value[2]	Less than 1 year	1 to 3 Years	Greater than 3 and up to 5 Years	Greater than 5 years
	(dollars in millions)					
Interest-rate swaps						
Pay-fixed	$ 135,758	$(13,178)	$ (167)	$ (522)	$(2,359)	$(10,130)
Receive-fixed	149,397	7,097	222	910	1,339	4,626
Basis (floating to floating)	4,941	(10)	1	(18)	(1)	8
Option-based	289,667	9,416	3,020	3,189	1,901	1,306
Futures	228,411	790	707	79	4	—
Foreign-currency swaps	43,687	5,054	2,439	1,218	330	1,067
Prepayment management agreement[4]	117,219	—	—	—	—	—
Commitments	191,563	253	253	—	—	—
Subtotal	1,160,643	9,422	$6,475	$4,856	$ 1,214	$ (3,123)
Credit derivatives[5]	17,301	4				
Total	$1,177,944	$ 9,426				

(1) Notional amounts are used to calculate the periodic amounts to be received and paid and generally do not represent actual amounts to be exchanged nor directly reflect our exposure to institutional credit risk. Notional amounts are not recorded as assets or liabilities in our consolidated balance sheets.
(2) The fair values for futures are directly derived from quoted market prices. Fair values of other derivatives are derived primarily from valuation models that incorporate relevant market data inputs obtained from third-party pricing services.
(3) Fair value is categorized based on the years from the date presented until the contractual maturity of the derivative.
(4) See "*Interest-Rate Risk Management and Use of Derivatives* — Types of Derivatives" for additional information concerning the nature of the prepayment management agreement.
(5) See "Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for more information about our credit derivatives.

The total fair value of our derivatives increased by $6.4 billion to $15.8 billion as of December 31, 2003 from $9.4 billion as of December 31, 2002. The increase was primarily due to the increase in the fair value of our pay-fixed swaps and foreign-currency swaps, partially offset by a decrease in the fair value of our receive-

fixed swap position. The increase in fair value of our pay-fixed swaps and foreign-currency swaps was a result of an increase in interest rates during the latter part of 2003 and a significant appreciation of the Euro relative to the U.S. dollar in 2003. See "CONSOLIDATED RESULTS OF OPERATIONS" and "CONSOLIDATED BALANCE SHEETS ANALYSIS" for more information regarding how these changes in fair value affect our financial results.

Table 50 provides a summary of the contractual terms of our pay-fixed and receive-fixed swaps. This table provides information about the effect of interest-rate swaps on net interest yield if the derivative is in a fair value or cash flow hedge relationship. If the derivative is classified as no hedge designation, the derivative does not affect our net interest yield, but rather is reported in Derivative gain (loss) on our consolidated statements of income.

Table 50 — Contractual Terms of Pay-Fixed and Receive-Fixed Swaps

	December 31, 2003					
	Pay-Fixed/ Receive-Variable			Receive-Fixed/ Pay-Variable		
	Notional	Pay Rate	Receive Rate[1]	Notional	Pay Rate[1]	Receive Rate
	(dollars in millions)					
Swaps						
Maturity less than 1 year	$ 4,900	5.76%	1.18%	$ 21,106	1.40%	2.38%
Maturity 1 to 3 years	31,073	2.69	1.17	18,247	1.73	3.88
Maturity greater than 3 and up to 5 years	15,967	3.63	1.17	11,249	1.99	3.99
Maturity in excess of 5 years	65,395	4.91	1.17	24,202	1.66	5.64
Subtotal	117,335			74,804		
Forward-starting swaps[2]						
Maturity 1 to 3 years	—	—	—	8,520	—	2.83
Maturity greater than 3 and up to 5 years	220	4.49	—	3,260	—	3.21
Maturity in excess of 5 years	62,196	6.11	—	20,833	—	5.07
Subtotal	62,416			32,613		
Total	$179,751			$107,417		

	December 31, 2002					
	Pay-Fixed/ Receive-Variable			Receive-Fixed/ Pay-Variable		
	Notional	Pay Rate	Receive Rate[1]	Notional	Pay Rate[1]	Receive Rate
	(dollars in millions)					
Swaps						
Maturity less than 1 year	$ 19,950	4.95%	1.52%	$ 18,116	1.45%	2.69%
Maturity 1 to 3 years	7,566	6.21	1.52	29,104	2.10	4.08
Maturity greater than 3 and up to 5 years	27,075	5.22	1.58	20,278	2.38	4.81
Maturity in excess of 5 years	38,153	6.40	1.50	41,680	2.04	5.51
Subtotal	92,744			109,178		
Forward-starting swaps[2]						
Maturity 1 to 3 years	—	—	—	2,646	—	2.65
Maturity greater than 3 and up to 5 years	54	4.15	—	2,533	—	5.69
Maturity in excess of 5 years	42,960	6.63	—	35,040	—	5.43
Subtotal	43,014			40,219		
Total	$135,758			$149,397		

(1) The weighted-average rate payable and receivable is as of the date indicated. Because the rates of the swaps are floating, these rates may change as prevailing interest rates change. The variable legs of these swaps are generally based on LIBOR or Euro Interbank Offered Rate, or EURIBOR.
(2) Represents interest-rate swap agreements scheduled to begin on a future date. Generally, the interest rate associated with the variable leg of the swap is set when the first payment cycle begins and is periodically reset thereafter.

As of December 31, 2003, the notional amount of our pay-fixed swaps was moderately higher than the notional amount of receive-fixed swaps. The notional amount of our net pay-fixed swap position was $72.3 billion, representing approximately $179.8 billion of pay-fixed swaps less approximately $107.4 billion of receive-fixed swaps. As shown in Table 50, the net pay-fixed swap position effectively results in payments at rates similar to long-term debt.

Measurement of Interest-Rate Risk

We actively manage interest-rate risk and other related market risks and take a disciplined approach to risk management. Throughout 2003 our interest-rate risk remained low.

PMVS and Duration Gap. Our interest-rate sensitivity disclosures provide a set of management estimates that convey a useful assessment of the amount of our interest-rate risk at a given point in time. This section describes our primary interest-rate risk measures: PMVS and duration gap. PMVS is measured in two ways, one measuring the estimated sensitivity of our portfolio market value (as defined below) to parallel moves in interest rates (PMVS-L) and the other to nonparallel movements (PMVS-YC). The LIBOR yield curve is used to estimate PMVS.

- PMVS-L shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our after-tax fair value of net assets attributable to common stockholders (measured as fair value of net assets less the fair value of preferred stock) from an immediate adverse 50 basis point parallel shift in the level of LIBOR rates (that is, when the yield at each point on the LIBOR yield curve increases or decreases by 50 basis points). The periodic disclosure in our Monthly Volume Summary report, which is available on our website at www.FreddieMac.com, reflects the average of the daily PMVS-L estimates for a given reporting period (a month, quarter or year).

  We believe the use of an immediate 50 basis point shift in the LIBOR yield curve is a conservative estimate of interest-rate risk. This estimate does not take into account any rebalancing actions that we would typically take to reduce risk exposure.

- PMVS-YC shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our after-tax fair value of net assets attributable to common stockholders, from an immediate adverse 25 basis point change in the slope (up and down) of the LIBOR yield curve. The periodic disclosure in our Monthly Volume Summary report, which is available on our website at www.FreddieMac.com, reflects the average of the daily PMVS-YC estimates for a given reporting period (a month, quarter or year).

- Duration gap estimates the net sensitivity of the fair value of our financial instruments to movements in interest rates. Duration gap is presented in units expressed as months. A duration gap of zero implies that the change in value of assets from an instantaneous rate move will be accompanied by an equal and offsetting move in the value of debt and derivatives thus leaving the net fair value of equity unchanged. However, because duration does not capture convexity exposure (the amount by which duration itself changes as rates move), actual changes in fair value from interest-rate changes may differ from those implied by duration gap alone. For that reason, management believes duration gap is most useful when used in conjunction with PMVS. The periodic duration gap disclosure in our Monthly Volume Summary report, which is available on our website at www.FreddieMac.com, reflects the average of the daily duration gap estimates for a given reporting period (a month, quarter or year).

In measuring the expected loss in portfolio market value, which is the numerator in the fraction used to calculate the PMVS percentages, we estimate the sensitivity to changes in interest rates of the fair value of all interest-bearing assets and liabilities, including short-term interest-bearing assets and liabilities and all derivatives on a pre-tax basis. When we calculate the expected loss in portfolio market value and duration gap, we also take into account the cash flows related to certain credit guarantee-related items, including net buy-ups (upfront payments made by us which increase the guarantee fee that we will receive in connection with our PC guarantee) and expected gains or losses due to net interest from security program cycles. In calculating the expected loss in portfolio market value and duration gap, we do not consider the sensitivity to interest-rate changes of the following assets and liabilities:

- *Guarantee fee portfolio.* Except for the guarantee-related items mentioned above (*i.e.*, net buy-ups and net interest from security program cycles), the sensitivity of the fair value of the guarantee fee portfolio to changes in interest rates is not included in calculating the expected loss in portfolio market value or duration gap because we believe the expected benefits from replacement business provide an adequate hedge against interest-rate changes.

- *Other assets with minimal interest-rate sensitivity.* Other assets, primarily including non-financial instruments such as fixed assets and REO, are not included in the calculation of the expected loss in portfolio market value or duration gap because of the minimal impact they would have on both PMVS and duration gap.

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

While PMVS and duration gap estimate the exposure of the fair value of net assets attributable to common stockholders to changes in interest rates, they do not capture the potential impact of certain other market risks, such as changes in volatility, basis, prepayment model, mortgage-to-debt spread and foreign currency risk. The impact of these other market risks can be significant. See "*Sources of Interest-Rate Risk and Other Market Risks*" for further information.

Our PMVS and duration gap measures provide useful estimates of key interest-rate risk exposures. These estimates are determined using models that involve interest-rate and prepayment assumptions made in our best judgment. In addition, in the case of PMVS, daily calculations are based on an estimate of the fair value of our net assets attributable to common stockholders since a complete fair value balance sheet is currently produced only on an annual basis. Accordingly, while we believe that PMVS and duration gap are useful risk management tools, they should be understood as estimates rather than precise measurements. We expect to provide quarterly consolidated fair value balance sheets as part of our 2004 financial statements and thereafter along with our quarterly financial reports.

Calculation of PMVS Measures. We calculate PMVS-L and PMVS-YC every business day. The 25 basis point change in slope for the PMVS-YC measure is obtained by shifting the two-year and ten-year LIBOR rates by an equal amount (12.5 basis points), but in opposite directions. LIBOR rate shifts between the two-year and ten-year points are interpolated. For each of PMVS-L and PMVS-YC, the more adverse loss on a pre-tax basis under both scenarios is then expressed as a percentage of the after-tax fair value of net assets attributable to common stockholders. These percentages represent the PMVS-L and PMVS-YC data points for the day. Neither PMVS-L nor PMVS-YC includes the effect on fair value of any rebalancing actions, despite the fact that we undertake frequent rebalancing actions that would reduce our exposure to loss in fair value relative to the potential losses the PMVS measure estimates.

Table 51 provides estimated point-in-time PMVS-L and PMVS-YC results as of December 31, 2003 and December 31, 2002. To supplement the PMVS-L results based on an assumed 50 basis point shift in the LIBOR yield curve, Table 51 also provides year-end PMVS-L estimates assuming an immediate 100 basis point shift in the LIBOR yield curve. Because we do not hedge all prepayment option risk, the duration of our mortgage assets changes more rapidly as changes in interest rates increase. Accordingly, as shown in Table 51, the PMVS-L results based on a 100 basis point shift in the LIBOR curve are disproportionately higher than

the PMVS-L results based on a 50 basis point shift in the LIBOR curve. We disclose the average daily, quarterly and annual PMVS-L and PMVS-YC results in our Monthly Volume Summary report.

Table 51 — Portfolio Market Value Sensitivity Assuming Shifts of the LIBOR Yield Curve

	Portfolio Market Value Sensitivity			Potential Dollar Loss in Portfolio Market Value (millions)		
	PMVS-YC	PMVS-L		PMVS-YC	PMVS-L	
	25 bp	50 bp	100 bp	25 bp	50 bp	100 bp
As of:						
December 31, 2003	0%	2%	9%	$ 20	$559	$2,171
December 31, 2002	2%	1%	4%	$356	$236	$ 764

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

Table 52 shows that the low PMVS-L average risk levels for the periods presented would generally have been substantially higher if we had not used derivatives to manage our interest-rate risk exposure.

As discussed above, PMVS-YC is determined by shifting the slope of the LIBOR yield curve between the two-year and ten-year points. We use derivatives across the entire yield curve in hedging our exposure to interest-rate risk. As liquidity and market conditions change, particularly in the ten-year sector, our use of derivatives may, from time to time, result in an increase in PMVS-YC. For example, our use of derivatives resulted in a significant decrease in overall interest-rate risk as measured by PMVS-L, but also caused a small increase in PMVS-YC as of December 31, 2002.

Table 52 — Derivative Impact on PMVS

	Before Derivatives	After Derivatives	Effect of Derivatives Increase (Decrease)
As of December 31, 2003			
PMVS-L (50bp)	6%	2%	(4)%
PMVS-YC (25bp)	0%	0%	0%
As of December 31, 2002			
PMVS-L (50bp)	19%	1%	(18)%
PMVS-YC (25bp)	1%	2%	1%

Calculation of Duration Gap Measure. On a daily basis, we estimate the fair value and effective duration of our financial assets and liabilities, including derivatives. The fair value of each instrument is multiplied by its duration to determine the instrument's duration dollars. Duration dollars are then aggregated to estimate the portfolio's net duration dollar exposure. To calculate duration gap, the net duration dollar exposure is divided by the fair value of total interest-bearing assets and expressed in months. We disclose the average daily, quarterly and annual duration gap in our Monthly Volume Summary report.

Table 53 — Duration Gap

Average for the Month of December,	Duration Gap (in months)
2003	0
2002	0

Credit Risks

Our total mortgage portfolio is subject to credit risks. See "Table 1 — Freddie Mac's Total Mortgage Portfolio Based on Unpaid Principal Balances" for more information on the composition of our total mortgage portfolio. We are subject to two types of credit risk — mortgage credit risk and institutional credit risk. Mortgage credit risk is the risk that a borrower will fail to make timely payments on a mortgage owned or guaranteed by us. Institutional credit risk is the risk that a counterparty that has entered into a business contract or arrangement with us will fail to meet its obligations.

Oversight of Credit Risks

The mission of the Credit Risk Oversight function is to provide independent oversight of the corporate-wide credit risk management functions, including asset selection, portfolio management, loss mitigation, and institutional counterparty risk. In particular, Credit Risk Oversight is responsible for providing senior management and the Board of Directions with regular, independent evaluations of whether credit risks are effectively identified, measured, managed, and controlled. As noted previously, in 2003 we placed Credit Risk Oversight within a new Enterprise Risk Oversight function, which reports directly to the Chief Executive Officer. The Models and Methods Oversight Group, also a part of the Credit Risk Oversight function, is responsible for independently assessing the design and adequacy of all key credit risk models.

Mortgage Credit Risk

Mortgage credit risk is the risk that we will not receive timely payments of principal and interest due from mortgage borrowers because of borrower defaults. This could result in losses if we are unable to collect amounts due through the sale of the underlying property, restructuring of the mortgage loan or the use of other loss mitigation activities. The discussion below describes our mortgage credit risk management strategies and summarizes our credit performance.

Mortgage Credit Risk Management Strategies. Our strategies for managing mortgage credit risk consist of four primary activities:

- Establishing and enforcing sound underwriting and quality control standards to evaluate the credit quality of the mortgage loans we securitize and purchase;
- Obtaining credit enhancements on higher-risk mortgages to secure partial protection against the risk of credit losses;
- Monitoring and managing portfolio diversification; and
- Executing loss mitigation activities to resolve non-performing loans and reduce our overall exposure to credit losses.

Underwriting and Quality Control Standards. We seek to ensure that the mortgages we securitize and purchase are protected by the borrower's willingness and ability to repay the mortgage obligation and by adequate equity in the underlying property. Automated underwriting software tools, such as Loan Prospector®, and other quantitative credit risk management tools are used to evaluate and monitor mortgage credit risk for single-family mortgages. Loan Prospector® combines loan-to-value ratios, credit scores and other mortgage and borrower characteristics to generate credit risk classifications. These statistically based risk assessments increase our ability, and the ability of mortgage lenders, to distinguish among single-family loans based on their likelihood of default.

For 2003 and 2002, Loan Prospector® was used to evaluate approximately 64 percent and 60 percent, respectively, of our single-family purchase volume prior to purchase. As part of our post-purchase quality control review process, we use Loan Prospector® to evaluate the credit quality of virtually all single-family mortgages that were not evaluated by Loan Prospector® prior to purchase. We also manage the quality of our single-family mortgage purchases by monitoring mortgage seller/servicers' compliance with our underwriting standards through quality control reviews, on-site audits and investigations of situations involving possible fraud. Particular focus is placed on performing quality control reviews of mortgage loans identified as high-

risk. Mortgage seller/servicers represent and warrant to us that mortgages are originated in compliance with our underwriting standards. We may require the seller/servicer to repurchase or accept losses on certain loans that do not comply with our underwriting standards.

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

Credit Enhancements. For most of the mortgage loans in our total mortgage portfolio (other than non-Freddie Mac mortgage-related securities and that portion of issued Structured Securities that is backed by Ginnie Mae Certificates), we retain the primary risk of loss in the event of default by the borrower on the underlying mortgage. Our charter requires that, to be eligible for purchase, single-family mortgages with loan-to-value ratios above 80 percent at the time of purchase be covered by (a) primary mortgage insurance or (b) certain other credit protections. In addition, for some mortgage loans, we elect to share the default risk by transferring a portion of that risk to various third parties through a variety of other credit enhancement vehicles. Mortgage loans covered by primary mortgage insurance and these other credit protections are referred to as credit-enhanced mortgages. Proceeds received from these credit enhancements are applied to offset credit losses and to Net interest income for that portion that represents forgone interest not previously recognized related to individual mortgage loans that default.

Table 54 shows the credit-enhanced portion of our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and Structured Securities issued by us that are backed by Ginnie Mae Certificates).

Table 54 — Credit-Enhanced Percentage of the Total Mortgage Portfolio(1)

	December 31,		
	2003	2002	2001
Credit-enhanced(2)	21%	27%	35%

(1) Based on the total mortgage portfolio excluding non-Freddie Mac mortgage-related securities and that portion of issued Structured Securities that is backed by Ginnie Mae Certificates. Non-Freddie Mac mortgage-related securities are excluded from this table because they expose us primarily to institutional credit risk. That portion of Structured Securities backed by Ginnie Mae Certificates is excluded because the incremental credit risk to which it exposes us is considered de minimus. See "Table 69 — Credit Characteristics of Non-Freddie Mac Mortgage-Related Securities" for additional information about our non-Freddie Mac mortgage-related securities.

(2) Credit enhancements include loans covered by primary mortgage insurance or for which the lender or a third party has retained primary default risk by pledging collateral or agreeing to accept losses on loans that default. In many cases, the lender's or third party's risk is limited to a specific level of losses at the time the credit enhancement becomes effective.

The percentage of our total mortgage portfolio (excluding Structured Securities backed by Ginnie Mae Certificates and non-Freddie Mac mortgage-related securities held by us) that was credit-enhanced decreased from 2001 to 2003. This decrease was primarily due to a high level of refinance loans acquired in 2003, which tend to have lower loan-to-value ratios and therefore do not require credit enhancements. Our ability and desire to expand the credit-enhanced portion of our total mortgage portfolio will depend on our evaluation of the credit quality of new business purchase opportunities and the future availability of effective credit enhancements at prices that permit an attractive return on credit-enhanced business.

Primary loan-level mortgage insurance, or primary mortgage insurance, is the most prevalent type of credit enhancement protecting our total mortgage portfolio and is obtained and paid for by borrowers on a loan level basis for single-family mortgages. Primary mortgage insurance transfers a significant portion of the credit risk associated with the mortgage to the insurer. Mortgage loans covered by primary mortgage insurance are included in our credit-enhanced portfolio.

After primary mortgage insurance, pool insurance is the next most prevalent type of credit enhancement protecting our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of issued Structured Securities that is backed by Ginnie Mae Certificates). With pool insurance, a

mortgage insurer provides insurance on a pool of loans up to a stated aggregate loss limit. Our pool insurance contracts typically cover losses ranging between about 0.70 percent and 1.85 percent of the aggregate unpaid principal balance of the pooled loans at the time of purchase. In addition to a pool-level loss coverage limit, some pool insurance contracts may have limits on coverage at the loan level. For pool insurance contracts that expire before the completion of the contractual term of the mortgage loan, we seek to ensure that the contracts cover the period of time during which we believe the mortgage loans are most likely to default.

Other forms of credit enhancements on single-family mortgage loans include reinsurance (an indemnity arrangement in which we pass all or a portion of the mortgage credit risk to another insurer), collateral (including cash or high-quality marketable securities) pledged by a lender, government guarantees, and recourse agreements (under which we may require a lender to repurchase loans that default).

For multifamily mortgages, we occasionally utilize credit enhancements to mitigate risk. The types of credit enhancements used for multifamily mortgage loans include recourse, third-party guarantees or letters of credit, purchases of senior participations in mortgage loans or structured pools, and cross-default and cross-collateralization provisions. With a cross-default provision, if the loan on a property goes into default, we have the right to declare specified other mortgage loans of the same borrower or its affiliates to be in default and to foreclose those other mortgages. With a cross-collateralization provision, we have the additional right to apply excess proceeds from the foreclosure of one mortgage to amounts owed to us by the same borrower relating to other multifamily mortgage loans we own. For information about our maximum coverage in regards to these credit enhancements, see "NOTE 4: FINANCIAL GUARANTEES" to the consolidated financial statements.

In 2003, the portion of the multifamily mortgage portfolio that was credit-enhanced increased as compared to 2002 and 2001. This was primarily the result of certain affordable housing transactions, where we acquired multifamily mortgage loans, which totaled approximately $7.5 billion at December 31, 2003, under agreements giving us recourse against the selling lender for any mortgage defaults.

While the use of credit enhancements reduces our exposure to mortgage credit risk, it increases our exposure to institutional credit risk. See "*Institutional Credit Risk*" for more information.

Portfolio Diversification. As part of our credit risk management practices, we monitor certain mortgage loan characteristics such as product mix, loan-to-value ratios and geographic concentration, which may affect the default experience on our mortgage portfolio.

Product Mix. Table 55 presents the distribution of underlying mortgage assets for total PCs issued and Structured Securities.

Table 55 — Freddie Mac Issued and Outstanding PCs and Structured Securities[1]

	December 31, 2003	
	Total Issued PCs and Structured Securities	Outstanding PCs and Structured Securities[2]
	(dollars in millions)	
Freddie Mac issued PCs and Structured Securities		
Single-family:		
Conventional:		
30-year fixed-rate[3]	$ 649,719	$449,281
15-year fixed-rate	355,800	197,677
ARMs/floating-rate[4]	81,184	39,868
Seconds[5]	2	2
FHA/VA	2,098	2,058
RHS and other federal guarantee loans	164	164
Alternative collateral deals[6]	17,486	11,478
Balloons/resets[7]	34,788	31,818
Structured Securities backed by Ginnie Mae Certificates[8]	4,729	4,059
Total single-family	1,145,970	736,405
Multifamily:		
Conventional	16,098	15,759
Total	$1,162,068	$752,164

	December 31, 2002	
	Total Issued PCs and Structured Securities	Outstanding PCs and Structured Securities[2]
	(dollars in millions)	
Freddie Mac issued PCs and Structured Securities		
Single-family:		
Conventional:		
30-year fixed-rate[3]	$ 695,177	$489,058
15-year fixed-rate	262,583	154,338
ARMs/floating-rate[4]	66,626	34,708
Seconds[5]	5	5
FHA/VA	1,513	1,427
RHS and other federal guarantee loans	134	134
Alternative collateral deals[6]	24,454	13,502
Balloons/resets[7]	22,499	20,457
Structured Securities backed by Ginnie Mae Certificates[8]	8,561	7,450
Total single-family	1,081,552	721,079
Multifamily:		
Conventional	9,072	8,730
Total	$1,090,624	$729,809

(1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
(2) Represents PCs and Structured Securities held by third parties.
(3) Also includes 20-year fixed-rate mortgages.
(4) Includes ARMs with 1-, 3-, 5-, 7- and 10-year initial fixed-rate periods.
(5) Represents mortgage loans on properties that are subordinate to the superior mortgage lien.
(6) Includes Structured Securities backed by non-agency mortgage-related securities, which are primarily backed by subprime mortgage loans, but also include some FHA/VA loans, home equity and other mortgage loans. The alternative collateral deal portion of outstanding PCs and Structured Securities consists of $2,577 million and $4,073 million of fixed-rate, $2,723 million and $5,945 million of ARMs/floating rate, $6,040 million and $3,484 million of FHA/VA and, $138 million and $-0- of seconds at December 31, 2003 and 2002, respectively.
(7) Mortgages whose terms require lump sum principal payments on contractually determined future dates unless the borrower qualifies for and elects an extension of the maturity date at an adjusted interest rate.
(8) The Ginnie Mae Certificates which underlie the Structured Securities are backed by FHA/VA loans.

Table 56 presents the distribution of unsecuritized whole mortgage loans held in our Retained portfolio.

Table 56 — Mortgage Loans Held in the Retained Portfolio[1]

	December 31,	
	2003	2002
	(dollars in millions)	
Single-family:		
Conventional		
Fixed-rate	$25,276	$33,192
Adjustable-rate	871	1,321
Seconds	1	3
Total Conventional	26,148	34,516
FHA/VA — Fixed-rate	513	705
RHS and other federal guarantee loans	613	629
Single-family	$27,274	$35,850
Multifamily Mortgages:		
Conventional	$32,993	$28,033
FHA/RHS	3	3
Total Multifamily	32,996	28,036
Total Mortgages	$60,270	$63,886

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

Product mix affects the credit risk profile of our total mortgage portfolio. In general, 15-year fixed-rate mortgages exhibit the lowest default rate among the types of single-family mortgage loans we securitize and purchase, due to the accelerated rate of principal amortization on these mortgages and the credit profiles of borrowers who seek and qualify for them. The next lowest rate of default is associated with 30-year fixed-rate mortgages. Balloon/reset mortgages and ARMs typically default at a higher rate than fixed-rate mortgages, although default rates for different types of ARMs may vary. While ARMs are typically originated with interest rates that are initially lower than those available for fixed-rate mortgages, their interest rates also change over time based on changes in an index or reference interest rate. As a result, the borrower's payments may rise or fall, within limits, as interest rates change. As payment amounts increase, the risk of default also increases. In the low interest rate environment experienced during 2002 and 2003, this trend was reversed with ARMs exhibiting lower default rates than fixed-rate mortgages.

The subprime segment of the mortgage market primarily serves borrowers with lower quality credit payment histories. These mortgages typically carry a higher risk of default. Our participation in this market helps to increase the availability of mortgage credit and reduce the costs of homeownership for a broader spectrum of borrowers.

We participate in the subprime market segment in two ways. First, our Retained portfolio makes investments in non-Freddie Mac mortgage-related securities that were originated in this market segment. Substantially all of these securities were rated "AAA" by one or more rating agencies at the time of purchase. These investments are included in the Single-family and other mortgage-related securities portion of our non-Freddie Mac mortgage-related securities portfolio shown in Table 69 — Credit Characteristics of Non-Freddie Mac Mortgage-Related Securities. Second, we guarantee securities backed by subprime mortgages. (These securities comprise a portion of our "alternative collateral deals.") These securities have previously been significantly credit enhanced and we obtain "shadow ratings" on these securities, which assess the risks of the securities without regard to the benefits of our guarantee. At the time of our purchase these securities were rated at least "BBB" (based on the S&P rating scale) by at least one nationally recognized credit rating agency. In addition to the non-Freddie Mac mortgage-related securities discussed above, our Retained portfolio makes investments in some of the Structured Securities issued in these transactions. In addition to our use of credit enhancements to manage our risk exposure to this segment of the market, we have established sophisticated monitoring techniques to continually evaluate our subprime exposure.

The distribution of the single-family loans underlying our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities

that is backed by Ginnie Mae Certificates) by original and estimated current loan-to-value ratio ranges, credit scores, loan purpose, property type and occupancy type is shown in Table 57.

Table 57 — Characteristics of Single-Family Mortgage Loan Portfolio[1]

	December 31,		
Original LTV Ratio Range[2]	**2003**	**2002**	**2001**
Less than 60%	26%	21%	18%
Above 60% to 70%	17	15	15
Above 70% to 80%	41	43	43
Above 80% to 90%	9	11	13
Above 90% to 95%	6	8	10
Above 95%	1	2	1
Total	100%	100%	100%
Weighted average original loan-to-value ratio	70%	72%	74%
Estimated Current LTV Ratio Range[3]			
Less than 60%	44%	45%	46%
Above 60% to 70%	20	19	19
Above 70% to 80%	23	22	21
Above 80% to 90%	9	9	9
Above 90% to 95%	3	3	3
Above 95%	1	2	2
Total	100%	100%	100%
Weighted average estimated current LTV ratio	61%	61%	61%
Credit Score			
Less than 620	4%	4%	4%
620 to 659	9	10	10
660 to 699	17	18	17
700 to 739	23	23	23
740 and above	44	39	36
Not Available	3	6	10
Total	100%	100%	100%
Weighted average credit score	723	718	717
Loan Purpose			
Purchase	25%	34%	43%
Cash-out refinance	26	25	21
Other refinance	49	41	36
Total	100%	100%	100%
Property Type			
1 unit	97%	97%	98%
2-4 units	3	3	2
Total	100%	100%	100%
Occupancy Type			
Primary residence	94%	94%	94%
Second/vacation home	3	3	3
Investment	3	3	3
Total	100%	100%	100%

(1) Based on the single-family mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by Ginnie Mae Certificates), which totaled $1,151 billion, $1,084 billion and $964 billion at December 31, 2003, 2002 and 2001, respectively.
(2) Our charter requires that mortgage loans purchased with loan-to-value ratios above 80 percent be covered by mortgage insurance or other credit enhancements.
(3) Current market values are estimated by adjusting the value of the property at origination based on changes in the market value of house prices since origination.

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

The likelihood of single-family mortgage default depends not only on the initial credit quality of the loan, but also on events that occur after origination. Accordingly, we monitor the loan-to-value ratio at the date of mortgage origination and the estimated current loan-to-value ratio, which compares the current unpaid principal balance of the mortgage to the estimated current market value of the property underlying the mortgage. Historical experience has shown that defaults are less likely to occur on mortgages with lower estimated current loan-to-value ratios. Furthermore, in the event of a default, higher levels of borrower equity in a property reduce the total amount of loss, thereby mitigating credit losses.

Credit Score. Credit scores are a useful measure for assuring the credit quality of a borrower. Credit scores are computer-generated numbers reported by the credit repositories, based on statistical models, that summarize an individual's credit record and predict the likelihood that a borrower will repay future obligations as expected. FICO® scores, or FICO, developed by Fair, Isaac and Co., Inc., are the most commonly used credit scores today. According to FICO, the various factors used to calculate credit scores can be grouped into five primary areas:

- Payment history;
- Outstanding debt;
- Length of credit history;
- Pursuit of new credit; and
- Types of credit in use.

FICO scores are ranked on a scale of approximately 300 to 850 points. Statistically, consumers with higher credit scores are more likely to repay their debts as expected than those with lower scores. The weighted average credit score for the total mortgage portfolio remained high at 723 at December 31, 2003, a slight increase from 718 at December 31, 2002 and 717 at December 31, 2001, indicating strong credit quality borrowers. In particular, the percentage of the mortgage loans with an available FICO score greater than 740 in the total mortgage portfolio has increased to 44 percent at December 31, 2003, from 39 percent at December 31, 2002 and 36 percent at December 31, 2001.

Loan Purpose. Mortgage loan purpose indicates how the borrower intends to use the funds from a mortgage loan. The three general categories are: purchase, cash-out refinance, or other refinance. In a purchase transaction, funds are used to acquire a property. In a cash-out refinance transaction, in addition to paying off an existing first mortgage lien, the borrowers obtain additional funds that may be used for other purposes including paying off subordinate mortgage liens and providing unrestricted cash proceeds to the borrower. In other refinance transactions, the funds are used to pay off an existing first mortgage lien and may be used in limited amounts for certain specified purposes; such refinances are generally referred to as "no cash-out" or "rate and term" refinances. Other refinance transactions also include refinance mortgages with respect to which the delivery data provided was not sufficient to determine that the mortgage was a cash-out or a no cash-out refinance transaction. The increase in refinance activity resulting from a reduction in interest rates increased the proportion of refinance mortgage loans in the total mortgage portfolio to a total of 75 percent, 66 percent and 57 percent at December 31, 2003, 2002 and 2001, respectively.

Property Type. Single-family mortgage loans are defined as mortgages secured by housing with up to four living units. Mortgages on one-unit properties tend to have lower credit risk than mortgage loans on multiple-unit properties. The proportion of one-unit properties in the total mortgage portfolio remained stable over the past three years, accounting for 97 percent, 97 percent and 98 percent at December 31, 2003, 2002 and 2001, respectively.

Occupancy Type. Borrowers may purchase a home as a primary residence, second/vacation home or investment property that is typically a rental property. Mortgage loans on properties occupied by the borrower as a primary or second residence tend to have a lower credit risk than mortgages on investment properties. The proportion of primary and secondary residences in the total mortgage portfolio remained the same over the past three years, accounting for 97 percent at December 31, 2003, 2002 and 2001.

Geographic Concentration. Due to our business model that involves purchasing mortgages from every geographic region in the U.S., we maintain a geographically diverse mortgage portfolio. This diversification provides protection from changing local and economic conditions. Table 58 shows the distribution of our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates) by geographic region. Our total mortgage portfolio's geographic distribution was relatively stable from 2002 to 2003, and remains broadly diversified across these five regions.

Table 58 — Geographic Concentration of the Total Mortgage Portfolio[1]

	December 31,			
	2003		2002	
	Total Mortgage Portfolio	% of Total Mortgage Portfolio	Total Mortgage Portfolio	% of Total Mortgage Portfolio
	(Dollars in Millions)		(Dollars in Millions)	
By Region[2]				
West	$ 295,349	24%	$ 294,681	26%
Northeast	285,789	24	264,843	23
North central	271,339	22	244,509	21
Southeast	213,646	18	200,476	18
Southwest	151,486	12	141,440	12
Total	$1,217,609	100%	$1,145,949	100%

(1) Based on the total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.
(2) See "NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS" to the consolidated financial statements for a description of these regions.

Loss Mitigation Activities. Despite our rigorous underwriting standards, some mortgage loans will become non-performing due to changes in general economic conditions, changes in the financial status of individual borrowers or other factors.

Table 59 summarizes our non-performing assets. The increase in our non-performing assets from 2000 through 2003 was primarily driven by higher delinquencies associated with our alternative collateral deals (credit enhanced securities backed by subprime mortgages). While these delinquencies result in higher levels of non-performing assets, we have limited loss exposure due to the credit enhancements associated with these securities.

Table 59 — Non-Performing Assets[1]

	December 31,			
	2003	2002	2001	2000
	(dollars in millions)			
Troubled debt restructurings, or TDRs[2][3]	$ 2,370	$2,164	$ 1,617	$1,389
Serious delinquencies[3][4]	7,470	6,830	5,070	3,546
Non-accrual loans[5]	21	47	44	9
Subtotal[6]	9,861	9,041	6,731	4,944
REO, net[7]	795	594	447	358
Total	$10,656	$9,635	$ 7,178	$5,302

(1) Information as of December 31, 1999 is omitted because we did not restate our consolidated financial statements for periods prior to 2000.

(2) Includes previously delinquent loans whose terms have been modified. Some of these loans may be performing as a result of the modified terms. TDRs are considered part of our impaired loan population. Figures presented are based on unpaid principal balances of mortgage loans. See "NOTE 6: LOAN LOSS RESERVES" to the consolidated financial statements for additional information on impaired loans.

(3) Subsequent to the issuance of our Information Statement dated February 27, 2004, we revised the amount of our serious delinquencies. The effect on serious delinquencies was a decrease of $401 million, $282 million and $208 million for the years ended December 31, 2002, 2001 and 2000, respectively.

(4) Includes single-family loans 90 days or more delinquent. For multifamily loans, the population includes all loans 60 days or more delinquent, but less than 90 days delinquent. Also included within this population are multifamily loans greater than 90 days past due but where principal and interest are being paid to us under the terms of a credit enhancement agreement. It also includes seriously delinquent loans in alternative collateral deals which totaled $2,793 million, $2,290 million, $1,052 million and $529 million at December 31, 2003, 2002, 2001 and 2000, respectively. See the discussion related to alternative collateral deal delinquencies following "Table 61 — Delinquency Performance."

(5) Non-accrual mortgage loans are loans for which interest income is recognized only on a cash basis and only includes multifamily loans that are 90 days or more delinquent. Balance represents 2, 3, 5 and 10 properties at December 31, 2003, 2002, 2001 and 2000, respectively. No single-family mortgage loans are classified as non-accrual. For single-family mortgages we recognize interest income on an accrual basis for all such loans, regardless of delinquency. We establish reserves for uncollectible interest that are estimated using statistical models, which quantify accrued but unpaid interest at the consolidated balance sheet date. Mortgage loans placed on non-accrual status are considered part of our impaired loan population.

(6) For the year ended December 31, 2003, $507 million was included in net interest income and management and guarantee income related to these mortgage loans (excluding interest income related to alternative collateral deals). The amount of forgone net interest income and additional management and guarantee income that we would have recorded had these loans been current is $42 million for the year ended December 31, 2003.

(7) For more information about REO balances, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" and "NOTE 7: REAL ESTATE OWNED."

Loss mitigation activities are a key component of our strategy for managing and resolving troubled assets and lowering credit losses. Our loss mitigation strategy emphasizes early intervention in delinquent mortgages and alternatives to foreclosure. Foreclosure alternatives are intended to reduce the number of delinquent mortgages proceeding to foreclosure and, ultimately, mitigate our total credit losses by eliminating a portion of

the costs related to foreclosed properties. Table 60 summarizes the number of loans involved in different types of single-family foreclosure alternatives.

Table 60 — Single-Family Foreclosure Alternatives[1]

	December 31,		
	2003	2002	2001
	(number of loans)		
Foreclosure Alternatives[2]			
Repayment plans	34,458	32,672	28,956
Loan modifications	8,508	7,951	5,107
Forbearance agreements	2,226	2,798	3,103
Pre-foreclosure sales[3]	1,755	1,531	1,222
Foreclosure alternatives	46,947	44,952	38,388

(1) Based on the single-family total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by non-Freddie Mac mortgage-related securities.
(2) Some mortgage loans may go through a foreclosure alternative more than once or may go through more than one type of foreclosure alternative.
(3) This amount includes third party sales and other foreclosure alternatives.

The increase in foreclosure alternatives from 2000 through 2003 was primarily driven by the increase in single-family delinquencies and an enhanced effort by us and servicers to pursue loss mitigation for homeownership preservation. Repayment plans, the most common type of foreclosure alternative, mitigate our credit losses because they assist borrowers in returning to compliance with the original terms of their mortgages. Loan modifications, the second most common type of foreclosure alternative, involve changing the terms of a mortgage and therefore are a more favorable alternative to the borrower during a declining interest-rate environment, such as we experienced during 2001, 2002 and the first half of 2003. Forbearance agreements, the third most common type of foreclosure alternative, provide a temporary suspension of the foreclosure process to allow additional time for the borrower to return to compliance with the original terms of the borrower's mortgage or to implement another foreclosure alternative.

Other single-family loss mitigation activities include additional default management tools designed to help single-family servicers manage non-performing loans more effectively. These tools include Early Indicator®, a system that estimates the probability that delinquent loans will be resolved or advanced through to a loss-producing state. In addition, we use Servicer Performance Profile reports to evaluate the performance of our mortgage servicers based on their management of performing and non-performing loans.

We typically require multifamily servicers to closely manage mortgage loans they have sold us in order to mitigate potential losses. Once a year, for loans over $1 million, servicers must generally submit an assessment of the mortgaged property to us based on an inspection of the property and a review of the property's financial statements. We also evaluate these assessments internally and may direct the servicer to take specific actions to reduce the likelihood of delinquency or default. If a loan defaults despite this intervention, we then determine whether it is in our best interest to offer a reasonable foreclosure alternative to the borrower. For example, we may modify the terms of a multifamily mortgage loan which gives the borrower an opportunity to bring the loan current and allows the borrower to retain ownership of the property. Since mortgage seller/servicers are an important part of our loss mitigation process, we rate their performance regularly and conduct on-site reviews of their servicing operations to confirm compliance with our standards.

Other Credit Risk Management Activities. We also participate in other activities such as risk-based pricing (which is a method of pricing mortgages based on credit risk factors such as the mortgage product type, loan purpose, loan-to-value ratio, and other loan attributes), financial incentives and credit derivatives, as described below, in situations where we believe they will benefit our credit risk management strategy. These arrangements are intended to reduce our credit-related expenses and to help us manage purchase quality, thereby ensuring adequate returns.

In accordance with our *Single-Family Seller/Servicer Guide* or as otherwise agreed with seller/servicers, certain mortgages are subject to risk-based pricing such as delivery fees in addition to periodic management and guarantee fees (through the Guarantor Program) or stated price (through the Cash Window Program).

These fees represent up-front pricing terms based on credit risk factors including the mortgage product type, loan purpose and other attributes.

In some cases, we also provide financial incentives in the form of lump sum payments to selected seller/servicers if they deliver a specified volume or share of mortgage loans meeting specified credit risk standards over a defined period of time. This financial incentive could also be in the form of a fee payable by the seller if the mortgages delivered to us do not meet certain credit standards.

We have also entered into risk-sharing agreements that are accounted for as derivatives in accordance with GAAP. Partially because the agreements may result in us making payments to the seller/servicer (depending upon actual default experience over the lives of the mortgages), they are considered credit derivatives, rather than financial guarantees under GAAP. Under these agreements, default losses on specific mortgage loans delivered by sellers are compared to default losses on reference pools of mortgage loans with similar characteristics. Based upon the results of that comparison, we remit or receive payments based upon the default performance of the specified mortgage loans. These payments are recorded in Management and guarantee income on the consolidated statements of income. The total notional amount of mortgage loans subject to these agreements was approximately $15.5 billion and $17.3 billion at December 31, 2003 and 2002, respectively. These risk-sharing agreements are classified as no hedge designation for purposes of applying SFAS 133, with changes in fair value recorded as Derivative gains (losses) on the consolidated statements of income. The fair value of these risk-sharing agreements is recorded in the Derivative assets, at fair value and Derivative liabilities, at fair value captions on the consolidated balance sheets, with net amounts of $5 million and $4 million in assets at December 31, 2003 and 2002, respectively.

Although these arrangements are part of our overall credit risk management strategy, they are not considered to be credit enhancements for purposes of describing our total mortgage portfolio characteristics because the financial incentive and credit derivative agreements may result in us making payments to the seller/servicer.

Credit Performance. The effectiveness of our credit risk management activities is reflected, in part, in the level of credit losses relative to our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates). To the extent we take on riskier assets, such as A- mortgages, and charge higher guarantee fees, credit losses may rise despite effective credit risk management activities. Therefore, while credit losses are a useful indicator of management activities, they must ultimately be considered relative to the revenue received for assuming the underlying credit risk. We may incur a credit loss when a borrower fails to make a mortgage payment, or is delinquent, and we either institute a foreclosure alternative or foreclose on the property. See "Mortgage Credit Risk Management Strategies — *Loss Mitigation Activities*" for more information. Credit losses are offset, in some cases, by payments received from credit enhancements and from income received on sale of foreclosed properties. Several key statistics that affect our credit losses are detailed in the tables below.

Delinquencies. Table 61 summarizes the delinquency performance of our single-family and multifamily mortgage portfolios. "Table 62 — Single-Family — Non-Credit-Enhanced Delinquencies — By Region" and "Table 63 — Single-Family — Mortgage Portfolio and Non-Credit-Enhanced Delinquencies — By Year of

Origination" provide a more detailed analysis of single-family delinquencies, by geographic region and year of origination.

Table 61 — Delinquency Performance[1]

	December 31,		
	2003	2002	2001
Single-family[2]			
Non-credit-enhanced portfolio			
Delinquency rate[3]	0.27%	0.28%	0.29%
Total number of delinquent loans[3]	21,063	20,946	19,612
Credit-enhanced portfolio[4]			
Delinquency rate[3]	2.96%	2.07%	1.30%
Total number of delinquent loans	66,283	58,768	41,970
Total portfolio[4]			
Delinquency rate	0.86%	0.77%	0.62%
Total number of delinquent loans	87,346	79,714	61,582
Multifamily[5]			
Total portfolio			
Delinquency rate	0.05%	0.13%	0.15%
Net carrying value of delinquent loans (in millions)	$ 24	$ 49	$ 44

(1) Based on the total mortgage portfolio, excluding both non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.
(2) Based on the number of mortgages 90 days or more delinquent or in foreclosure.
(3) Subsequent to the issuance of our 2003 and prior years results announced in our Information Statement Supplement dated June 30, 2004 and our Information Statement dated February 27, 2004, we revised our delinquency rates. The effect of this change on non-credit-enhanced delinquency rates was a decrease of 0.01 percent for each of the years ended December 31, 2002 and 2001, and no impact for the year ended December 31, 2003. The effect of this change on credit-enhanced delinquency rates was an increase of 0.01 percent for each of the years ended December 31, 2003, 2002 and 2001. The effect of this change on the total number of delinquent loans in the non-credit-enhanced portfolio was a decrease of 508, 480 and 521 for the years ended December 31, 2003, 2002 and 2001, respectively, and a corresponding increase in the total number of delinquent loans in the credit-enhanced portfolio of 508, 480 and 521 for the years ended December 31, 2003, 2002 and 2001, respectively.
(4) Includes alternative collateral deals.
(5) Based on net carrying value of mortgages 60 days or more delinquent or in foreclosure.

The single-family total portfolio delinquency rate increased by 9 basis points from December 31, 2002 to 0.86 percent at December 31, 2003. This increase was driven by the single-family credit-enhanced delinquency rate, which increased by 89 basis points from year-end 2002 to 2.96 percent at December 31, 2003. The increase in the credit-enhanced delinquency rate was primarily due to rising delinquencies associated with alternative collateral deals. The subprime mortgage loans associated with alternative collateral deals typically experience delinquency rates that are significantly higher than prime conventional mortgage loans, but the securities that we guarantee in these deals are significantly credit-enhanced. The single-family total portfolio delinquency rate, excluding these alternative collateral deals, was 0.56 percent, 0.53 percent and 0.50 percent for the years ended December 31, 2003, 2002 and 2001, respectively. The multifamily delinquency rate was 0.05 percent at December 31, 2003, down from 0.13 percent at December 31, 2002. Multifamily delinquencies include mortgage loans where the borrowers are not paying as agreed, but principal and interest are being paid to us under the terms of a credit enhancement agreement.

Table 62 presents delinquency rates for the non-credit-enhanced portion of the single-family loans underlying our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates) by geographic region.

Table 62 — Single-Family — Non-Credit-Enhanced Delinquencies — By Region(1) (2)

	December 31,		
	2003	2002	2001
Northeast	0.28%	0.30%	0.37%
Southeast(3)	0.32	0.34	0.30
North central(3)	0.27	0.27	0.25
Southwest	0.28	0.28	0.25
West(3)	0.19	0.23	0.28
Total all regions(3)	0.27%	0.28%	0.29%

(1) Based on the number of mortgages 90 days or more delinquent or in foreclosure.
(2) See "NOTE 17: CONCENTRATION OF CREDIT RISK AND OTHER RISKS" to the consolidated financial statements for a description of these regions.
(3) Subsequent to our Information Statement dated February 27, 2004, we revised the results for non-credit-enhanced delinquencies by region. The impact of this change on rates reported for Southeast, North central and Total all regions was a decrease of 0.01% for each of the years ended December 31, 2002 and 2001. The impact also decreased West rates by 0.01% for the year ended December 31, 2001.

The total non-credit-enhanced delinquency rate at December 31, 2003 decreased slightly as compared to December 31, 2002. Regional delinquency trends varied in 2003. The northeast, southeast and west had declining delinquency rates, while the north central and southwest regions' delinquency rates remained unchanged.

Table 63 presents the distribution of the single-family loans underlying our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates) and non-credit-enhanced delinquency rates by year of origination.

Table 63 — Single-Family — Mortgage Portfolio and Non-Credit-Enhanced Delinquencies — By Year of Origination

	December 31,					
	2003		2002		2001	
Year of Origination	Percent of Single-Family Balance(1)	Non-Credit-Enhanced Delinquency Rate	Percent of Single-Family Balance(1)	Non-Credit-Enhanced Delinquency Rate(2)	Percent of Single-Family Balance(1)	Non-Credit-Enhanced Delinquency Rate(2)
Pre-1996	5%	0.65%	9%	0.52%	16%	0.50%
1996	1	0.90	2	0.70	4	0.60
1997	1	0.82	3	0.51	5	0.35
1998	4	0.45	11	0.26	19	0.18
1999	3	0.73	8	0.44	15	0.27
2000	1	1.78	3	0.91	8	0.40
2001	10	0.48	26	0.19	33	0.04
2002	24	0.18	38	0.05	—	—
2003	51	0.01	—	—	—	—
Total	100%	0.27%	100%	0.28%	100%	0.29%

(1) Single-family total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.
(2) Subsequent to our Information Statement dated February 27, 2004, we revised the results for our non-credit-enhanced delinquencies by year of origination for 2002 and 2001. The overall impact on the total non-credit-enhanced delinquency rate was a decrease of 0.01 percent for each of the years ended December 31, 2002 and 2001.

Our single-family portfolio distribution by origination year was affected by heavy refinance volumes in recent years. As of December 31, 2003, 85 percent of our single-family mortgage portfolio consisted of mortgage loans originated in 2001, 2002 or 2003. Mortgage loans originated in 2000 and earlier, which represent only approximately 15 percent of our single-family mortgage portfolio, have delinquency rates that are generally higher than the overall portfolio delinquency rate due primarily to the weaker credit quality of these loans. For instance, mortgage loans originated in 2000 were generally for purchase transactions, which are typically of weaker credit quality, as opposed to refinancing transactions. As a result, we have experienced higher than average early defaults and delinquency rates on these mortgage loans originated in 2000, but they represent only one percent of the single-family total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates).

Credit Loss Performance. Some of the loans that are delinquent or in foreclosure result in credit losses. Table 64 provides detail on our credit loss performance, including REO activity, charge-offs and credit losses.

Table 64 — Credit Loss Performance

	Year Ended December 31,		
	2003	2002	2001
	(dollars in millions)		
REO			
REO balances:			
Single-family	$ 758	$ 593	$ 446
Multifamily	37	1	1
Total	$ 795	$ 594	$ 447
REO activity (number of properties):(1)			
Beginning property inventory	7,222	5,713	4,564
Properties acquired	17,750	13,520	10,091
Properties disposed	(15,802)	(12,011)	(8,942)
Ending property inventory	9,170	7,222	5,713
Average holding period (in days)(2)	174	185	186
REO operations income (expense):			
Single-family	$ 26	$ 13	$ (6)
Multifamily	(3)	—	(1)
Total	$ 23	$ 13	$ (7)
CHARGE-OFFS			
Single-family:			
Foreclosure alternatives, gross	$ (40)	$ (46)	$ (33)
Recoveries(3)	17	17	12
Foreclosure alternatives, net	(23)	(29)	(21)
REO acquisitions, gross	(176)	(124)	(95)
Recoveries(3)	101	65	77
REO acquisitions, net	(75)	(59)	(18)
Single-family totals:			
Charge-offs, gross	(216)	(170)	(128)
Recoveries(3)	118	82	89
Single-family charge-offs, net	(98)	(88)	(39)
Multifamily:			
Charge-offs, gross	(8)	(1)	(1)
Recoveries(3)	1	2	3
Multifamily charge-offs, net	(7)	1	2
Total Charge-offs:			
Charge-offs, gross	(224)	(171)	(129)
Recoveries:			
Related to primary mortgage insurance	94	61	74
Not related to primary mortgage insurance	25	23	18
Total recoveries(3)	119	84	92
Charge-offs, net	$ (105)	$ (87)	$ (37)
CREDIT GAINS (LOSSES)(4)			
Single-family	$ (72)	$ (75)	$ (45)
Multifamily	(10)	1	1
Total	$ (82)	$ (74)	$ (44)
In basis points:(5)			
Single-family	0.6	0.7	0.5
Multifamily	0.1	—	—
Total	0.7	0.7	0.5

(1) Includes single-family and multifamily REO properties.
(2) Represents weighted average holding period for single-family and multifamily based on number of REO properties disposed. Subsequent to our Information Statement dated February 27, 2004, we revised our method for calculating weighted average holding period. The impact of this change was a decrease of 1 day each for the years ended December 31, 2002 and 2001.
(3) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where the primary default risk has been assumed by servicers, mortgage insurers, or other third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in many instances to amounts less than the full amount of the loss.
(4) Equal to REO operations income (expense) plus Charge-offs, net.
(5) Calculated as credit gains (losses) divided by the average total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

Overall, we continued to demonstrate very strong credit performance during 2003, driven by effective risk management and the sustained strength of the single-family housing market. The following discussion provides additional analysis on key credit loss-related statistics and results.

When we foreclose on a property, it may become part of our REO inventory. REO operations income (expense), a component of credit losses, includes the expenses incurred to foreclose, acquire, maintain and sell a property. REO inventory levels increased in 2003, both in terms of dollar amount and number of properties held. The single-family REO balance was $758 million at December 31, 2003, up from $593 million and $446 million at December 31, 2002 and 2001, respectively. The increase in the single-family REO balance during 2002 and 2003 is consistent with rising delinquency rates and general softening in the economy. Although REO inventories increased, single-family REO income (expense) improved to an income of $26 million and $13 million in 2003 and 2002, respectively, from an expense of $6 million in 2001 largely due to house-price growth, recoveries from credit enhancements and reimbursements from seller/servicers. REO income arises when the fair market value of the acquired asset exceeds the carrying value of the mortgage loan or when we are able to sell the REO at amounts in excess of its carrying value.

Charge-offs, another component of credit losses, include losses and recoveries on mortgages that are transferred to REO or involved in a foreclosure alternative. Single-family charge-offs, net of recoveries, increased from $39 million in 2001 to $88 million and $98 million in 2002 and 2003, respectively, largely due to increased REO acquisitions as described above. Charge-offs, net are reflected on our consolidated balance sheets as a reduction in loan loss reserves. See "Table 67 — Loan Loss Reserves Activity" for more information.

Credit losses remained relatively low in 2003 for both single-family and multifamily mortgage portfolios. Single-family credit losses totaled $72 million, or 0.6 basis points of the average total mortgage portfolio, in 2003. This represents a slight increase from the historically low levels of single-family credit losses experienced in 2001 ($45 million or 0.5 basis points) and a slight decrease from single-family credit losses experienced in 2002 ($75 million or 0.7 basis points). In the multifamily business, we experienced a credit loss of $10 million in 2003, and gains of $1 million in both 2001 and 2002. The 2003 increase in the credit losses in the multifamily business is primarily driven by the foreclosure of one property in 2003. The multifamily market has weakened in recent years due to the softening economy. Although this has resulted in higher vacancies and declines in rent growth, property values generally have remained stable. As a result, despite the weakening multifamily market, our multifamily delinquencies have remained low (see "Table 61 — Delinquency Performance") and multifamily credit losses have remained relatively low in 2003.

Table 65 and Table 66 provide detail by region for two key credit performance statistics, REO activity and charge-offs. Regional REO acquisition and charge-off trends follow a pattern that is similar to that of regional delinquency trends. The southeast, north central and southwest regions experienced the largest increases in REO acquisitions in 2003 compared to 2002, caused by the particularly severe impact of the economic recession in 2001 and 2002 on employment rates in those regions, while the northeast and west regions experienced slight declines.

Table 65 — REO Activity — By Region[1]

	Year Ended December 31,		
	2003	2002	2001
	(number of properties)		
REO Inventory			
Beginning property inventory	7,222	5,713	4,564
Properties acquired by region:			
Northeast	1,600	1,683	1,784
Southeast	5,378	3,533	2,398
North central	4,643	3,180	1,959
Southwest	3,503	2,435	1,513
West	2,626	2,689	2,437
Total properties acquired	17,750	13,520	10,091
Properties disposed by region:			
Northeast	(1,674)	(1,798)	(1,959)
Southeast	(4,476)	(3,012)	(1,895)
North central	(3,908)	(2,420)	(1,577)
Southwest	(3,018)	(2,019)	(1,150)
West	(2,726)	(2,762)	(2,361)
Total properties disposed	(15,802)	(12,011)	(8,942)
Ending property inventory	9,170	7,222	5,713

(1) See "NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS" to the consolidated financial statements for a description of these regions.

Table 66 — Single-Family Charge-offs and Recoveries By Region[1][2]

	Year Ended December 31,		
	2003	2002	2001
	(dollars in millions)		
Northeast			
Charge-offs	$ 21	$ 27	$ 25
Recoveries	(8)	(10)	(6)
Charge-offs, net	13	17	19
Southeast			
Charge-offs	62	42	20
Recoveries	(35)	(19)	(16)
Charge-offs, net	27	23	4
North central			
Charge-offs	54	31	12
Recoveries	(29)	(18)	(14)
Charge-offs, net	25	13	(2)
Southwest			
Charge-offs	43	28	41
Recoveries	(26)	(14)	(39)
Charge-offs, net	17	14	2
West			
Charge-offs	36	42	30
Recoveries	(20)	(21)	(14)
Charge-offs, net	16	21	16
Total			
Charge-offs	216	170	128
Recoveries	(118)	(82)	(89)
Charge-offs, net	$ 98	$ 88	$ 39

(1) See "NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS" to the consolidated financial statements for a description of these regions.
(2) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where the primary default risk has been assumed by servicers, mortgage insurers, or other third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in many instances to amounts less than the full amount of the loss.

Table 67 summarizes our loan loss reserves activity.

Table 67 — Loan Loss Reserves Activity[1]

	Year Ended December 31,			
	2003	2002	2001	2000
	(dollars in millions)			
Total loan loss reserves[2]:				
Beginning balance	$ 265	$ 224	$ 229	$ 217
Provision for credit losses	10	128	32	79
Charge-offs	(224)	(171)	(129)	(124)
Recoveries[3]	119	84	92	57
Charge-offs, net	(105)	(87)	(37)	(67)
Adjustment for change in accounting[4]	110	—	—	—
Transfers-in during the period[5]	19	—	—	—
Ending balance	$ 299	$ 265	$ 224	$ 229
Charge-offs, net to total mortgage portfolio[6]	0.9bp	0.8bp	0.4bp	0.8bp
Coverage ratio (reserves to charge-offs, net)	2.8	3.0	6.1	3.4

(1) Information for the year ended December 31, 1999 is omitted because we did not restate our consolidated financial statements for periods prior to 2000.
(2) Includes Reserves for loans held for investment in the Retained portfolio and Reserves for guarantee losses on Participation Certificates. See "NOTE 6: LOAN LOSS RESERVES" to the consolidated financial statements for more details.
(3) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where the primary default risk has been assumed by servicers, mortgage insurers, or third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in many instances to amounts less than the full amount of the loss.
(4) On January 1, 2003, that portion of recognized guarantee obligations that was attributable to estimated incurred losses on outstanding PCs or Structured Securities, of $110 million, was reclassified to Reserve for guarantee losses on Participation Certificates.
(5) Represents estimated losses that were incurred in 2003 related to PCs and Structured Securities transferred to third parties in 2003.
(6) Calculated using the average total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

We maintain our two loan loss reserves — Reserve for losses on mortgage loans held for investment and Reserve for guarantee losses on Participation Certificates — at levels we deem adequate to absorb probable losses on mortgage loans held for investment in the Retained portfolio and certain mortgages underlying PCs held by third parties. In certain circumstances, incurred losses related to PCs we hold are captured in our PC residuals, which represent the fair value of the PCs related to guarantee asset and guarantee obligation. See "CRITICAL ACCOUNTING POLICIES — Loan Loss Reserves" and "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for further information.

Loan loss reserves are increased through periodic charges to the provision for credit losses and decreased by charges-offs, net of recoveries. We record charge-offs to the loan loss reserves when the loss is specifically identifiable and virtually certain. For mortgages that are transferred to REO or involved in a pre-foreclosure sale, we record losses at the time of transfer or sale. For loans that have been modified, losses are recorded at the time of modification if the modification is a troubled debt restructuring.

As shown in "Table 67 — Loan Loss Reserves Activity," total loan loss reserves increased in 2003. This increase was primarily due to the transfer-in of $129 million as a result of the reclassification of incurred losses previously included in the "Guarantee obligation for Participation Certificates" in conjunction with the implementation of FIN 45 and the ongoing recognition of the portion of the guarantee obligation that represents incurred losses for PCs initially established at fair value, offset by higher net charge-offs recorded during 2003.

Credit Risk Sensitivity. As a part of our voluntary disclosure commitments made in October 2000, we provide public disclosure of credit risk sensitivity results on a quarterly basis. The credit risk sensitivity analysis assesses the assumed increase in the present value of expected single-family mortgage portfolio losses over 10 years as the result of an estimated instantaneous 5 percent decline in house prices nationwide, followed by a return to more normal growth in house prices based on historical experience. An internally developed Monte Carlo simulation-based model is used to generate our credit risk sensitivity analyses. The Monte Carlo model uses an interest rate simulation program to generate numerous interest rate paths that, in conjunction with a

prepayment model, are used to estimate mortgage cash flows along each path. We use this same model to calculate the expected default cost component of the "Guarantee obligation on Participation Certificates" and to estimate expected future default costs of mortgage loans and mortgage-related securities. In this analysis, we adjust the house-price assumption used in the base case to estimate the level and sensitivity of potential credit costs resulting from a sudden decline in housing prices. See "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to the consolidated financial statements for more information.

The credit risk sensitivity results are shown in Table 68. The credit-risk sensitivity results show an estimated increase of $84 million in the net present value of the increase in credit losses of $533 million after receipt of credit enhancements as of December 31, 2003 compared to December 31, 2002. Credit risk sensitivity results as of the end of each quarter in 2003 and the first two quarters of 2004 are presented in "VOLUNTARY COMMITMENTS."

Table 68 — Credit Risk Sensitivity — Estimated Net Present Value (NPV) of Increase in Credit Losses[1]

	Before Receipt of Credit Enhancements[2]		After Receipt of Credit Enhancements[3]	
	NPV	NPV Ratio[4]	NPV	NPV Ratio[4]
	(dollars in millions, except ratios)			
As of:				
December 31, 2003	$926	7.9bps	$533	4.6bps
December 31, 2002	$948	8.5bps	$449	4.0bps

(1) Based on single-family total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.
(2) Assumes that none of the credit enhancements currently covering our mortgages has any mitigating impact on our credit losses.
(3) Assumes we collect amounts due from credit enhancement providers after giving effect to certain assumptions about counterparty default rates.
(4) Calculated as the ratio of net present value of increase in credit losses to the single-family total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

Institutional Credit Risk

We are subject to credit risk from institutional counterparties to the extent they do not fulfill their obligations to us under the terms of specific contracts or agreements. Our primary institutional credit risk exposure, other than counterparty credit risk exposure relating to derivatives (which is discussed in "Interest-Rate Risk and Other Market Risks — *Derivative-Related Risks* — Derivative Counterparty Credit Risk"), arises from agreements with the following entities:

- Mortgage seller/servicers;
- Mortgage insurers;
- Issuers or guarantors of, or third party providers of credit enhancements on, non-Freddie Mac mortgage-related securities held in our Retained portfolio;
- Mortgage investors and originators; and
- Issuers, guarantors and insurers of investments held in our cash and investments portfolio.

Mortgage Seller/Servicers. We are exposed to institutional credit risk arising from the insolvency of mortgage seller/servicers that remit to us monthly principal and interest payments on mortgages, provide credit enhancements such as recourse or collateral and represent and warrant that mortgages were originated in compliance with our standards (see "*Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies — *Credit Enhancements*" for more information). Our exposure includes mortgage seller/servicers who have agreed to repurchase or accept losses on certain loans that default or do not comply with our standards. To protect us against this risk, we require servicers to meet minimum net worth, insurance and other eligibility requirements, and we institute remedial actions against mortgage seller/servicers that fail to comply with our standards. These actions may include transferring mortgage servicing to other qualified servicers or terminating our relationship with the mortgage seller/servicer. Due to the large number of firms competing in the mortgage servicing market, we have not experienced difficulty in finding replacement

servicers to accept transfers of servicing on mortgages owned by us when servicers are unable or unwilling to meet our standards of performance.

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

Mortgage Loan Insurers. We bear institutional credit risk relating to the non-performance of mortgage insurers that insure purchased or guaranteed mortgages (see "*Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies — *Credit Enhancements"* for more information). We manage this risk by regularly monitoring our exposure to individual mortgage insurers. We monitor the mortgage insurers' credit ratings, as provided by nationally recognized credit rating agencies. In addition, we periodically review the methods used by the credit rating agencies. We also perform periodic on-site audits of mortgage insurers to confirm compliance with our eligibility requirements and to evaluate their management and control practices. In addition, state insurance authorities regulate mortgage insurers. Substantially all mortgage insurers providing primary mortgage insurance and pool insurance coverage on single-family mortgages purchased during 2003 were rated "AA" or better by S&P. At December 31, 2003, there were 6 mortgage insurers, the largest being Mortgage Guarantee Insurance Corporation, that each provided more than 5 percent of our total mortgage insurance coverage (including primary mortgage insurance and pool insurance) and together accounted for approximately 95 percent of our overall coverage.

Non-Freddie Mac Mortgage-Related Securities. Investments for our Retained portfolio expose us to institutional credit risk on non-Freddie Mac mortgage-related securities to the extent that issuers or guarantors, or third parties providing credit enhancements, become insolvent. Table 69 summarizes the credit characteristics of our non-Freddie Mac mortgage-related securities.

Table 69 — Credit Characteristics of Non-Freddie Mac Mortgage-Related Securities[1]

	December 31,			
	2003		2002	
	Dollars in Millions	% AAA Rated[2]	Dollars in Millions	% AAA Rated[2]
Agency mortgage-related securities:				
Fannie Mae	$ 74,529	100%	$ 78,829	100%
Ginnie Mae	2,760	100	4,878	100
Total agency mortgage-related securities	77,289	100	83,707	100
Non-agency mortgage-related securities:				
Single-family and other mortgage-related securities[3]	72,161	100	43,799	99
Commercial mortgage backed securities[4]	33,055	99	24,559	99
Mortgage revenue bonds[5]	7,772	77	7,640	81
Manufactured housing[6]	1,784	42	2,394	48
Total non-agency mortgage-related securities	114,772	97	78,392	96
Total non-Freddie Mac mortgage-related securities	$192,061	98	$162,099	98

(1) See "Table 1 — Freddie Mac's Total Mortgage Portfolio Based on Unpaid Principal Balances" for more information.
(2) Includes percentage of non-Freddie Mac mortgage-related securities rated "AAA" or equivalent. Agency mortgage-related securities are generally not separately rated by credit rating agencies, but are viewed as having a level of credit quality at least equivalent to non-agency mortgage securities rated AAA. Credit rating of non-agency mortgage-related securities is designated by at least two nationally recognized credit rating agencies.
(3) Among other categories of securities, includes securities backed by subprime home equity loans, which are typically first-lien mortgages made to borrowers with a higher risk of default.
(4) Consists of commercial mortgage securities backed by pools of loans including significant amounts of multifamily mortgages.
(5) Consists of obligations of state and political subdivisions.
(6) 84 percent and 100 percent of mortgage-related securities backed by manufactured housing were rated BBB or above at December 31, 2003 and 2002, respectively. For the same periods, 90 percent and 84 percent of these securities were credit-enhanced. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for our impairment policies.

Our non-Freddie Mac mortgage-related securities portfolio consists of both agency and non-agency mortgage securities. Agency mortgage-related securities, which are securities issued, guaranteed, or both

issued and guaranteed by Fannie Mae and Ginnie Mae, present minimal institutional credit risk exposure to us due to the high credit quality of the issuers and guarantors. Agency mortgage-related securities are generally not separately rated by credit rating agencies, but are viewed as having a level of credit quality at least equivalent to non-agency mortgage securities rated AAA (based on the S&P rating scale or an equivalent rating from other nationally recognized rating agencies). At December 31, 2003, we held approximately $77 billion of agency securities, representing approximately 6 percent of our total mortgage portfolio (see "Table 1 — Freddie Mac's Total Mortgage Portfolio Based on Unpaid Principal Balances" for more information about our total mortgage portfolio).

Non-agency mortgage securities expose us to some institutional credit risk, which is mitigated through credit enhancements such as bond insurance. Substantially all of the bond insurers providing coverage for non-agency mortgage securities held by us were rated AAA or equivalent by at least one nationally recognized credit rating agency. At December 31, 2003, we held approximately $115 billion of non-agency mortgage securities, representing approximately 8 percent of our total mortgage portfolio. Of this amount, 97 percent were rated AAA or equivalent.

We manage institutional credit risk on non-Freddie Mac mortgage-related securities by only purchasing securities that meet our stringent investment guidelines and performing ongoing analysis to evaluate the creditworthiness of the issuers and servicers of these securities and the bond insurers that guarantee them. To assess the creditworthiness of non-agency securities, we may perform additional analysis, including on-site visits, verification of loan documentation, review of underwriting or servicing processes and similar due diligence measures. In addition, management regularly evaluates these investments to determine if any impairment in fair value requires an impairment loss recognition in earnings, warrants divestiture, or a combination of both. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for more information on impairments.

Mortgage Investors and Originators. We are exposed to pre-settlement risk through the purchase, sale and financing of mortgage loans and mortgage-related securities with mortgage investors and originators, primarily in our SS&TG business unit. Pre-settlement risk is the risk that a counterparty will not perform under the terms of a transaction due to adverse changes in market value between trade date and settlement date. The probability of such a default is generally remote over the short time horizon between the trade and settlement date. We manage this risk by evaluating the creditworthiness of our counterparties and monitoring and managing our exposures. In some instances, we may require these counterparties to post collateral.

Cash and Investments Portfolio. Institutional credit risk also arises from the insolvency of issuers or guarantors of investments held in our cash and investments portfolio. This portfolio is used to meet both anticipated and unanticipated liquidity and working capital requirements (See "LIQUIDITY AND CAPITAL RESOURCES — Liquidity" for more information). Instruments in this portfolio are investment grade at the time of purchase and primarily short-term in nature, thereby significantly mitigating institutional credit risk in this portfolio. We regularly evaluate these investments to determine if any impairment in fair value requires an impairment loss recognition in earnings, warrants divestiture, or a combination of both. See "LIQUIDITY AND CAPITAL RESOURCES — Table 38 — Mortgage-Related and Non Mortgage-Related Securities in the Cash and Investment Portfolio" for credit ratings of the mortgage-related and non-mortgage-related securities in the cash and investments portfolio.

QUARTERLY SELECTED FINANCIAL DATA

	2003				
	1Q	2Q	3Q	4Q	Full-Year
	(dollars in millions)				
Net interest income	$2,421	$2,185	$2,442	$2,450	$ 9,498
Non-interest income (loss)	1,243	1,827	(2,299)	(1,030)	(259)
Non-interest expense	(406)	(610)	(557)	(648)	(2,221)
Income tax (expense) benefit	(991)	(1,096)	126	(241)	(2,202)
Net income (loss)	$2,267	$2,306	$ (288)	$ 531	$ 4,816
Basic earnings (loss) per common share(2)	$ 3.22	$ 3.28	$(0.49)	$ 0.70	$ 6.69
Diluted earnings (loss) per common share(2)	$ 3.21	$ 3.27	$(0.49)	$ 0.69	$ 6.68

	2002				
	1Q	2Q	3Q	4Q	Full-Year
	(dollars in millions)				
Net interest income(1)	$2,544	$2,352	$2,231	$2,398	$ 9,525
Non-interest income (loss)(1)	(780)	983	6,543	397	7,143
Non-interest expense	(354)	(401)	(333)	(777)	(1,865)
Income tax (expense) benefit	(463)	(963)	(2,779)	(508)	(4,713)
Net income (loss)	$ 947	$1,971	$5,662	$1,510	$10,090
Basic earnings (loss) per common share (as previously reported)(2)(3)	$ 1.28	$ 2.76	$ 8.08	$ 2.11	$ 14.23
Basic earnings (loss) per common share (as restated)(2)(3)	$ 1.27	$ 2.76	$ 8.08	$ 2.11	$ 14.22
Diluted earnings (loss) per common share (as previously reported)(2)(3)	$ 1.27	$ 2.74	$ 8.06	$ 2.10	$ 14.18
Diluted earnings (loss) per common share (as restated)(2)(3)	$ 1.26	$ 2.74	$ 8.06	$ 2.10	$ 14.17

(1) In accordance with interpretive guidance published by the Office of the Chief Accountant of the SEC, we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in a qualifying hedge accounting relationship, from Income (expense) related to derivatives, a component of Net interest income, to Derivative gains (losses), a component of Non-interest income, for all periods presented. These reclassifications, which decreased Derivative gains (losses) and increased Income (expense) related to derivatives, totaled $130 million, $229 million, $152 million and $128 million for first, second, third and fourth quarters of 2002, respectively, or $639 million on a full-year 2002 basis.

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

(3) In accordance with the requirements of EITF D-42, we restated the 2002 amount of "Preferred stock dividends and issuance costs on redeemed preferred stock" reported on our consolidated statements of income. For the year ended December 31, 2002 and for the first quarter of 2002, the restatement increased by $5 million the amount representing issuance costs on redeemed preferred stock and therefore reduced net income available to common stockholders by $5 million. This caused a reduction in both basic and diluted earnings per share for the same periods of $0.01 per share. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements for additional information.

SUBSEQUENT ACCOUNTING REVISIONS

Subsequent to the announcement of our 2003 financial results in our Information Statement Supplement dated June 30, 2004 we made the following revisions:

- We recorded an expense of $75 million to establish a reserve for legal proceedings arising from the restatement. This reserve was recorded in the second quarter of 2003, the period in which many of the legal proceedings were initiated. For additional information see "NOTE 13: LEGAL CONTINGENCIES" to the consolidated financial statements;
- We changed the period in which we reported the $125 million OFHEO civil money penalty. This amount is now reported in the second quarter of 2003, the period in which OFHEO commenced its special investigation, and was previously reported in the fourth quarter of 2003. For additional information see "NOTE: 13: LEGAL CONTINGENCIES" to the consolidated financial statements; and
- We decreased the balance of our Accounts and other receivables, net and increased Other assets by $306 million on the consolidated balance sheets as of December 31, 2003.

Additionally, in accordance with the requirements of EITF D-42, we restated the 2002 amount of Preferred stock dividends and issuance costs on redeemed preferred stock reported on our consolidated statements of income. For the year ended December 31, 2002 and for the first quarter of 2002, the restatement increased by $5 million the amount representing issuance costs on redeemed preferred stock and therefore reduced net income available to common stockholders by $5 million. This caused a reduction in both basic and diluted earnings per share for the same periods of $0.01 per share. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" in the consolidated financial statements for additional information.

VOLUNTARY COMMITMENTS

The following provides updated information on the Voluntary Commitments we made in October 2000. Additional information about our Voluntary Commitments is available on our website (www.FreddieMac.com/investors).

Description	Comments	Status
1. *Periodic Issuance of Subordinated Debt:*		
• We will issue publicly traded and externally rated Freddie SUBS on a semi-annual basis.		• We did not issue any Freddie SUBS in 2003. As a result of not having timely consolidated financial statements, our ability to issue subordinated debt may be limited.
• Freddie SUBS will be issued in an amount such that "Voluntary Commitments' capital" less 0.45 percent of Outstanding PCs and Structured Securities held by third parties will equal or exceed 4 percent of on-balance sheet assets by October 2003. Voluntary Commitments' capital is defined as the sum of Core capital (effectively equal to Stockholders' equity less AOCI, net of taxes), loan loss reserves and Freddie SUBS outstanding.	• At December 31, 2003, the ratio of Voluntary Commitments' capital less 0.45 percent of Outstanding PCs and Structured Securities held by third parties to total assets, was 4.4 percent.	• As of December 31, 2003, we met this commitment.
	• We cannot determine this ratio as of the end of any period in 2004 with specificity until we release the consolidated financial statements for the relevant period.	• We plan to update our disclosure for this commitment following the release of our 2004 consolidated financial statements.

Description	Comments	Status
2. *Liquidity Management and Contingency Planning:*		
• We will comply with principles of sound liquidity management set forth by the Basel Committee on Banking Supervision and will maintain more than three months' worth of liquidity (based on internal forecasts) assuming we have no access to new issue public debt markets.	• For purposes of this commitment, we will maintain liquidity needed to meet our obligations to pay principal and interest related to our outstanding debt maturities, to pay PC investors the amounts due to them, to purchase mortgage loans and mortgage-related securities that we have committed to purchase as well as to fund operating expenditures. To fund these obligations in the event of market disruption, we could sell securities from our Retained portfolio, and liquidate non-mortgage investments or liquidate mortgage-related investments held by SS&TG, both of which are a component of Cash and Investments as reported on our consolidated balance sheet. In addition, we could borrow against mortgage-related securities that are a component of our Retained portfolio by executing transactions in the repurchase agreement market. (Our ability to execute these and other strategies may be adversely affected by market conditions, operational constraints and other factors.)	• As of December 31, 2003, we met this commitment.
• In implementing this commitment, we will maintain at least 5 percent of on-balance sheet assets in liquid, marketable, non-mortgage securities. We will also maintain additional, liquid mortgage securities for use as collateral in short-term borrowings from dealer counterparties.	• Assets that meet this definition include cash and cash equivalents (excluding operating cash accounts, cash posted as collateral by derivative counterparties and certain other balances), various non-mortgage investments such as municipal bonds, corporate bonds, asset-backed securities, commercial paper and certain securities purchased under agreements to resell (reverse repos). These assets do not include investments or reverse repos held by SS&TG or as part of our external money manager program.	• As of December 31, 2003, we met this commitment.
	• We cannot determine the percentage of on-balance sheet assets in liquid, marketable, non-mortgage securities as of the end of any period in 2004 with specificity until we release the consolidated financial statements for the relevant period.	• We plan to update our disclosures for this commitment following the release of our 2004 consolidated financial statements.
3. *Interest-Rate Risk Disclosures* We will provide public disclosure of interest-rate risk sensitivity results on a monthly basis. Specifically, we will disclose the PMVS-L, which shows the expected impact on our portfolio market value from an immediate, adverse 50 basis point parallel shift in the yield curve. We will also disclose the PMVS-YC, which shows the same impact from an immediate, adverse 25 basis point change in the slope of the yield curve.		The monthly average PMVS-L and PMVS-YC for December 2003 was 3 and 0 percent, respectively. 2004's monthly average PMVS results and related disclosures are provided in our Monthly Volume Summary, which is available on our website, www.FreddieMac.com/investor.

VOLUNTARY COMMITMENTS (continued)

<table>
<tr><th>Description</th><th>Comments</th><th>Status</th></tr>
<tr>
<td>4. Credit Risk Disclosures:

We will provide public disclosure of credit risk sensitivity results on a quarterly basis. Compared to a base case in which house prices on average rise at rates consistent with long-term trends, these disclosures show the increase in the present value of expected single-family credit losses to Freddie Mac over a 10-year period assuming an immediate 5 percent decline in house prices followed by a resumption of the same long-term trend in house-price appreciation as in the base case.</td>
<td>An internally developed Monte Carlo simulation-based model is used to generate our credit risk sensitivity analyses. We use this same model to calculate the expected default cost component of the Guarantee obligation on Participation Certificates and to estimate expected future default costs of mortgage loans and mortgage-related securities. In this analysis, we adjust the house-price assumption used in the base case to estimate the level and sensitivity of potential credit costs associated with our existing single-family mortgage portfolio. See "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to the consolidated financial statements for more information.</td>
<td>Our quarterly credit risk sensitivity estimates are as follows:

<table>
<tr><th></th><th colspan="2">Before Receipt of Credit Enhancements(1)(2)</th><th colspan="2">After Receipt of Credit Enhancements(1)(3)</th></tr>
<tr><th></th><th>NPV</th><th>NPV Ratio(4)</th><th>NPV</th><th>NPV Ratio(4)</th></tr>
<tr><th></th><th>(dollars in millions)</th><th></th><th>(dollars in millions)</th><th></th></tr>
<tr><td>As of:</td><td></td><td></td><td></td><td></td></tr>
<tr><td>06/30/04(5)</td><td>$873</td><td>7.3 bps</td><td>$522</td><td>4.4 bps</td></tr>
<tr><td>03/31/04(5)</td><td>872</td><td>7.4 bps</td><td>503</td><td>4.3 bps</td></tr>
<tr><td>12/31/03</td><td>926</td><td>7.9 bps</td><td>533</td><td>4.6 bps</td></tr>
<tr><td>09/30/03</td><td>947</td><td>8.5 bps</td><td>537</td><td>4.8 bps</td></tr>
<tr><td>06/30/03</td><td>931</td><td>8.6 bps</td><td>493</td><td>4.6 bps</td></tr>
<tr><td>03/31/03</td><td>933</td><td>8.5 bps</td><td>493</td><td>4.5 bps</td></tr>
<tr><td>12/31/02</td><td>948</td><td>8.5 bps</td><td>449</td><td>4.0 bps</td></tr>
</table>

(1) Based on single-family total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.
(2) Assumes that none of the credit enhancements currently covering our mortgages has any mitigating impact on our credit losses.
(3) Assumes we collect amounts due from credit enhancement providers after giving effect to certain assumptions about counterparty default rates.
(4) Calculated as the ratio of net present value of increase in credit losses to the total mortgage portfolio.
(5) 2004 information is based on preliminary portfolio balances as reported in the Monthly Volume Summary available at our website, www.FreddieMac.com/investors.</td>
</tr>
<tr>
<td>5. Public Disclosure of Annual Rating:

We will obtain an annual credit rating assessing risk to the government or independent financial strength from a nationally recognized statistical rating organization and will disclose this rating to the public.</td>
<td>We have a "risk-to-the-government" credit rating of "AA−" from S&P. Moody's has assigned us a Bank Financial Strength Rating of "A−." Both of these ratings are maintained on a surveillance basis, which means that the rating agencies are committed to notify the public if the rating is ever affected by a change in our financial condition.</td>
<td>As of May 6, 2004, S&P affirmed its rating of "AA-" for risk-to-the-government and as of June 30, 2004 Moody's confirmed its "A-" Bank Financial Strength Rating. A comparable rating from Fitch has not yet been disclosed publicly.</td>
</tr>
</table>

CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

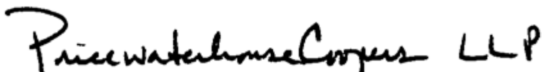
REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders of Freddie Mac:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows, and of stockholders' equity present fairly, in all material respects, the financial position of Freddie Mac, a stockholder-owned government-sponsored enterprise (the "company"), and its subsidiaries at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We have also audited in accordance with auditing standards generally accepted in the United States of America the supplemental consolidated fair value balance sheets of the company as of December 31, 2003 and 2002. As described in "Note 16: Fair Value Disclosures", the supplemental consolidated fair value balance sheets have been prepared by management to present relevant financial information that is not provided by the historical-cost consolidated balance sheets and is not intended to be a presentation in conformity with generally accepted accounting principles. In addition, the supplemental consolidated fair value balance sheets do not purport to present the net realizable, liquidation, or market value of the company as a whole. Furthermore, amounts ultimately realized by the company from the disposal of assets or amounts required to settle obligations may vary significantly from the fair values presented. In our opinion, the supplemental consolidated fair value balance sheets referred to above present fairly, in all material respects, the information set forth therein as described in "Note 16: Fair Value Disclosures."

As discussed in "Note 1: Summary of Significant Accounting Policies", the company adopted the provisions of FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" and FASB Staff Position 45-2 "Whether FASB Interpretation No. 45, 'Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,' Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value," as of January 1, 2003. As discussed in the same note, the company adopted the provisions of Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" and the provisions of Emerging Issues Task Force No. 99-20 "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," as of January 1, 2001 and April 1, 2001, respectively.



McLean, Virginia
September 9, 2004

FREDDIE MAC
CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	2003	2002	2001
	(dollars in millions, except share-related amounts)		
Interest income			
Mortgage loans	$ 4,251	$ 4,290	$ 4,385
Mortgage-related securities in the Retained portfolio	29,051	30,039	26,847
Cash and investments	3,796	4,147	4,136
Total interest income	37,098	38,476	35,368
Interest expense			
Short-term debt	(2,785)	(4,303)	(9,056)
Long-term debt	(22,083)	(21,337)	(17,494)
Total interest expense on debt securities	(24,868)	(25,640)	(26,550)
Due to Participation Certificate investors	(1,641)	(1,236)	(1,027)
Total interest expense	(26,509)	(26,876)	(27,577)
Income (expense) related to derivatives	(1,091)	(2,075)	(343)
Net interest income	9,498	9,525	7,448
Non-interest income			
Management and guarantee income (includes interest on Guarantee asset for Participation Certificates of $244, $242 and $252)	1,638	1,516	1,392
Gains (losses) on "Guarantee asset for Participation Certificates, at fair value"	(1,461)	(2,176)	(789)
Income (expense) on "Guarantee obligation for Participation Certificates"	925	592	203
Derivative gains (losses)	39	5,302	(2,313)
Hedge accounting gains (losses)	644	187	(294)
Gains (losses) on investment activity	(1,114)	1,799	191
Gains (losses) on debt retirement	(1,775)	(674)	(356)
Resecuritization fees	352	276	135
Other income	493	321	229
Non-interest income (loss)	(259)	7,143	(1,602)
Non-interest expense			
Provision for credit losses	(10)	(128)	(32)
REO operations income (expense)	23	13	(7)
Salaries and employee benefits	(624)	(593)	(537)
Occupancy expense	(52)	(42)	(35)
Housing tax credit partnerships	(200)	(160)	(121)
Minority interests in earnings of consolidated subsidiaries	(157)	(184)	(208)
Other expenses	(1,201)	(771)	(452)
Non-interest expense	(2,221)	(1,865)	(1,392)
Income before income tax expense and cumulative effect of change in accounting principles	7,018	14,803	4,454
Income tax expense	(2,202)	(4,713)	(1,339)
Income before cumulative effect of change in accounting principles, net of taxes	4,816	10,090	3,115
Cumulative effect of change in accounting principles, net of taxes of $24	—	—	43
Net income	$ 4,816	$ 10,090	$ 3,158
Preferred stock dividends and issuance costs on redeemed preferred stock (including $—, $5 and $— of issuance costs on redeemed preferred stock)	(216)	(239)	(217)
Net income available to common stockholders	$ 4,600	$ 9,851	$ 2,941
Basic earnings per common share before cumulative effect of change in accounting principles, net of taxes	$ 6.69	$ 14.22	$ 4.19
Cumulative effect of change in accounting principles, net of taxes	—	—	0.06
Basic earnings per common share after cumulative effect of change in accounting principles, net of taxes	$ 6.69	$ 14.22	$ 4.25
Diluted earnings per common share before cumulative effect of change in accounting principles, net of taxes	$ 6.68	$ 14.17	$ 4.17
Cumulative effect of change in accounting principles, net of taxes	—	—	0.06
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes	$ 6.68	$ 14.17	$ 4.23
Weighted average common shares outstanding (thousands)			
Basic	687,094	692,727	692,603
Diluted	688,675	695,116	695,973
Dividends per common share	$ 1.04	$ 0.88	$ 0.80

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

FREDDIE MAC
CONSOLIDATED BALANCE SHEETS

	December 31, 2003	December 31, 2002
	(dollars in millions)	
Assets		
Retained portfolio		
Mortgage loans:		
Held for investment, at amortized cost	$ 57,804	$ 57,483
Reserve for losses on mortgage loans held for investment	(174)	(177)
Held for sale, at lower of cost or market value	2,530	6,635
Mortgage loans, net of reserve	60,160	63,941
Mortgage-related securities:		
Available for sale, at fair value (includes $282 and $367 pledged as collateral that may be repledged)	581,326	496,265
Trading, at fair value (includes $32 and $89 pledged as collateral that may be repledged)	18,200	29,104
Participation Certificate residuals, at fair value	671	412
Total mortgage-related securities	600,197	525,781
Retained portfolio	660,357	589,722
Cash and investments		
Cash and cash equivalents	23,142	10,792
Investments:		
Mortgage-related securities:		
Trading, at fair value (includes $6 and $2 pledged as collateral that may be repledged)	32,817	32,366
Participation Certificate residuals, at fair value	(5)	8
Non-mortgage-related securities:		
Available for sale, at fair value (includes $— and $350 pledged as collateral that may be repledged)	31,228	66,419
Trading, at fair value (includes $23 and $62 pledged as collateral that may be repledged)	1,314	2,409
Total non-mortgage-related securities	32,542	68,828
Total mortgage-related and non-mortgage-related securities	65,354	101,202
Securities purchased under agreements to resell and Federal funds sold	20,582	23,043
Cash and investments	109,078	135,037
Accounts and other receivables, net	8,067	10,611
Derivative assets, at fair value	16,180	10,393
Guarantee asset for Participation Certificates, at fair value	3,686	2,445
Real estate owned, net	795	594
Other assets	5,286	3,447
Total assets	$803,449	$752,249
Liabilities and stockholders' equity		
Debt securities, net		
Senior debt:		
Due within one year	$295,262	$244,429
Due after one year	438,738	415,662
Subordinated debt, due after one year	5,613	5,605
Total debt securities, net	739,613	665,696
Due to Participation Certificate investors	13,205	35,080
Accrued interest payable	7,345	7,286
Guarantee obligation for Participation Certificates	2,904	1,427
Derivative liabilities, at fair value	357	967
Reserve for guarantee losses on Participation Certificates	125	88
Other liabilities	6,484	8,066
Total liabilities	770,033	718,610
Commitments and contingencies		
Minority interests in consolidated subsidiaries	1,929	2,309
Stockholders' equity		
Preferred stock, at redemption value	4,609	4,609
Common stock, $0.21 par value, 726,000,000 shares authorized, 725,882,280 shares issued and 688,573,911 shares and 687,375,999 shares outstanding, respectively	152	152
Additional paid-in capital	814	744
Retained earnings	28,837	24,955
Accumulated other comprehensive income (loss), (AOCI) net of taxes, related to:		
Available-for-sale securities	6,349	12,217
Cash flow hedge relationships	(7,837)	(9,877)
Minimum pension liability	(10)	—
Total accumulated other comprehensive income (loss), net of taxes	(1,498)	2,340
Treasury stock, at cost, 37,308,369 shares and 38,506,281 shares, respectively	(1,427)	(1,470)
Total stockholders' equity	31,487	31,330
Total liabilities and stockholders' equity	$803,449	$752,249

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

FREDDIE MAC
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Year Ended December 31,					
	2003		2002		2001	
	Shares	Amount	Shares	Amount	Shares	Amount
	(dollars and shares in millions)					
Preferred stock, at redemption value						
Balance, beginning of year	92	$ 4,609	92	$ 4,596	64	$ 3,195
Preferred stock issuances	—	—	6	300	28	1,401
Preferred stock redemptions	—	—	(6)	(287)	—	—
Preferred stock, end of year	92	4,609	92	4,609	92	4,596
Common stock, par value						
Balance, beginning of year	726	152	726	152	726	152
Common stock, end of year	726	152	726	152	726	152
Additional paid-in capital						
Balance, beginning of year		744		671		624
Stock-based compensation, before tax effect of $23, $23 and $21		64		65		60
Income tax benefit from employee stock option exercises		16		16		30
Preferred stock issuance costs		—		(2)		(13)
Common stock issuances		(10)		(6)		(30)
Additional paid-in capital, end of year		814		744		671
Retained earnings						
Balance, beginning of year		24,955		15,710		13,326
Net income		4,816		10,090		3,158
Preferred stock dividends declared		(216)		(234)		(217)
Common stock dividends declared		(718)		(611)		(557)
Retained earnings, end of year		28,837		24,955		15,710
AOCI, net of taxes						
Balance, beginning of year		2,340		(557)		1,084
Changes in unrealized gains (losses) related to available-for-sale securities, net of reclassification adjustments		(5,868)		8,017		3,116
Changes in unrealized gains (losses) related to cash flow hedge relationships, net of reclassification adjustments		2,040		(5,120)		(2,117)
Change in minimum pension liability		(10)		—		—
Cumulative effect of change in accounting principle		—		—		(2,640)
AOCI, net of taxes, end of year		(1,498)		2,340		(557)
Treasury stock, at cost						
Balance, beginning of year	39	(1,470)	31	(948)	33	(1,024)
Common stock issuances	(2)	43	(1)	33	(2)	76
Common stock repurchases	—	—	9	(555)	—	—
Treasury stock, end of year	37	(1,427)	39	(1,470)	31	(948)
Total stockholders' equity		$31,487		$31,330		$19,624
Comprehensive income						
Net income		$ 4,816		$10,090		$ 3,158
Changes in AOCI, net of taxes, net of reclassification adjustments		(3,838)		2,897		(1,641)
Total comprehensive income		$ 978		$12,987		$ 1,517

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

FREDDIE MAC
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2003	2002	2001
	(dollars in millions)		
Cash flows from operating activities			
Net income	$ 4,816	$ 10,090	$ 3,158
Adjustments to reconcile net income to net cash provided by operating activities:			
Cumulative effect of change in accounting principles (pre-tax)	—	—	(67)
Hedge accounting (gains) losses	(644)	(187)	294
Unrealized (gains) losses on derivatives not in hedge accounting relationships, net	(1,079)	(5,941)	1,857
Asset amortization — premiums, discounts and hedging basis adjustments	995	(404)	(645)
Debt amortization — premiums and discounts on long-term debt and hedging basis adjustments	2,458	1,272	547
Losses on debt retirement	1,775	674	356
Provision for credit losses	10	128	32
(Gains) losses on investment activity	2,625	(1,784)	(231)
(Decrease) increase in deferred income taxes	737	2,690	(245)
Purchases of held-for-sale mortgages	(82,074)	(55,275)	(24,837)
Sales of held-for-sale mortgages	84,329	49,035	20,362
Repayments of held-for-sale mortgages	390	1,097	262
Net decrease in trading securities	8,935	7,170	2,535
Change in accounts and other receivables, net	4,206	1,678	1,345
Change in amounts due to Participation Certificate investors, net	(21,875)	7,705	20,879
Change in accrued interest payable	(40)	344	1,237
Change in income taxes payable	(1,090)	(484)	601
Change in Guarantee asset for Participation Certificates, at fair value	(1,362)	711	(381)
Change in Guarantee obligation for Participation Certificates	1,606	272	378
Change in Participation Certificate residuals, at fair value	(389)	326	(9)
Other, net	153	2,647	(2,639)
Net cash provided by operating activities	4,482	21,764	24,789
Cash flows from investing activities			
Purchases of available-for-sale securities	(446,036)	(451,510)	(387,561)
Proceeds from sales of available-for-sale securities	142,167	172,964	102,771
Proceeds from maturities of available-for-sale securities	243,390	182,955	141,699
Purchases of held-for-investment mortgages	(18,602)	(13,656)	(13,735)
Repayments of held-for-investment mortgages	15,841	13,372	13,197
Proceeds from sales of REO	1,369	980	771
Net decrease (increase) in securities purchased under agreements to resell and Federal funds sold	2,461	10,457	(24,084)
Derivative premiums and terminations, net	3,333	(4,062)	(2,202)
Investments in housing tax credit partnerships	(32)	(65)	(77)
Net cash used for investing activities	(56,109)	(88,565)	(169,221)
Cash flows from financing activities			
Proceeds from issuance of short-term debt	900,073	2,048,131	2,455,070
Repayments of short-term debt	(882,000)	(2,100,103)	(2,362,620)
Proceeds from issuance of long-term debt	258,371	269,386	205,213
Repayments of long-term debt	(210,841)	(141,257)	(150,316)
Repayments of minority interest in consolidated subsidiaries	(376)	(350)	(325)
Proceeds from issuance of preferred stock, net of issuance costs	—	298	1,388
Redemption of preferred stock	—	(287)	—
Proceeds from issuance of common stock	33	27	46
Repurchases of common stock	—	(555)	—
Payment of cash dividends on preferred stock and common stock	(934)	(845)	(774)
Repayments of housing tax credit partnerships notes payable	(349)	(316)	(186)
Net cash provided by financing activities	63,977	74,129	147,496
Net increase (decrease) in cash and cash equivalents	12,350	7,328	3,064
Cash and cash equivalents at beginning of period	10,792	3,464	400
Cash and cash equivalents at end of period	$ 23,142	$ 10,792	$ 3,464
Supplemental cash flow information			
Cash paid for:			
Interest	$ 22,852	$ 21,994	$ 18,324
Derivative interest carry	578	3,239	244
Income taxes	2,538	2,491	977
Non-cash investing and financing activities:			
Securitized and retained available-for-sale securities formed from prior period purchases of held-for-sale mortgages	1,681	2,910	362
Transfers from mortgage loans to REO	1,663	1,197	910
Investments in housing tax credit partnerships financed by notes payable	702	896	427
Transfers from available-for-sale securities to trading securities in conjunction with the implementation of SFAS 133	—	—	36,336
Transfers from held-for-sale mortgages to held-for-investment mortgages	179	209	411

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Freddie Mac (the "company") is a stockholder-owned, government-sponsored enterprise ("GSE") established by Congress in 1970 to provide a continuous flow of funds for residential mortgages. Freddie Mac's obligations are the company's alone and not insured or guaranteed by the United States ("U.S.") or any other agency or instrumentality of the U.S.

Freddie Mac plays a fundamental role in the American housing finance system, linking the domestic mortgage market and the global capital markets. Freddie Mac's participation in the secondary mortgage market includes providing its credit guarantee for residential mortgages originated by mortgage lenders and investing in mortgage loans and mortgage-related securities held in Freddie Mac's Retained portfolio. Through credit guarantee activities, Freddie Mac securitizes mortgage loans by issuing Participation Certificates ("PCs") to third party investors. Freddie Mac also resecuritizes mortgage-related securities that are issued by Freddie Mac, the Federal National Mortgage Association ("Fannie Mae") or the Government National Mortgage Association ("Ginnie Mae"), as well as nonagency entities. Securities issued through Freddie Mac's resecuritization activities are referred to as "Structured Securities." Freddie Mac also guarantees multifamily mortgage loans that support housing revenue bonds issued by third parties and it guarantees other mortgage loans held by third parties, which are included in the definition of PCs and Structured Securities. In each case, under generally accepted accounting principles ("GAAP"), securitized mortgage-related assets that back PCs and Structured Securities that are held by third parties are not reflected as assets of Freddie Mac. However, Freddie Mac does retain an obligation to guarantee the payment of principal and interest on issued PCs and Structured Securities, which usually results in the recognition of a guarantee asset and guarantee obligation on the company's consolidated balance sheets.

Freddie Mac's financial reporting and accounting policies conform to GAAP. Certain amounts in prior periods have been reclassified to conform to the current presentation.

Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect (a) the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and (b) the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The use of certain estimates in preparation of the financial statements is described below.

A significant estimate that is pervasive in the company's financial statements is the estimation of fair value for financial instruments required to be recorded at fair value under GAAP. The measurement of fair value is fundamental to the presentation of Freddie Mac's financial condition and results of operations and, in many instances, requires management to make complex judgments. In general, Freddie Mac records financial instruments at an estimate of the amount at which the instrument could be bought and sold between willing parties, in an active market and not in a forced or liquidation sale. Fair value is generally based on quoted prices or market parameters obtained from third-party dealers or pricing services in active markets or derived from such prices or parameters, where available. If quoted prices or market parameters are not available, fair value is based on internal valuation models using market data inputs or internally developed assumptions, where appropriate. The use of different pricing models and assumptions could produce materially different estimates of fair value. See "NOTE 16: FAIR VALUE DISCLOSURES" for further discussion of fair value estimates.

Estimates are also used to determine the expected future cash flows (including the timing and amounts of prepayments) of mortgage-related assets in the Retained portfolio, to assess the reserves for credit losses on mortgage loans and guarantee losses on PCs, to assess Freddie Mac's legal and tax contingencies, to estimate the expected timing and amounts of future redemptions of callable debt, and to determine other matters that affect the reported amounts and disclosure of contingencies in the financial statements. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 5 "Accounting for Contingencies" ("SFAS 5"), contingencies that might result in gains are not recorded prior to realization; whereas, contingencies that result in losses are accrued currently if it is probable a liability has been incurred and the

amount is reasonably estimable. Loss contingencies that are considered reasonably possible are not accrued, but are required to be disclosed. Loss contingencies that are considered to have a remote probability of occurrence are not required to be accrued or disclosed in accordance with SFAS 5.

Consolidation

The consolidated financial statements include the accounts of the company and its subsidiaries. All material intercompany transactions have been eliminated in consolidation. For each entity with which Freddie Mac is involved, the company makes a determination as to whether the entity should be considered a subsidiary of the company and included in the company's consolidated financial statements. Freddie Mac consolidates all subsidiaries in which it holds more than 50 percent of the voting rights and has the ability to exercise control over the entity. The company uses the equity method of accounting for companies over which it has the ability to exercise significant influence but not control. Under the equity method of accounting, Freddie Mac reports its recorded investment as an asset on the consolidated balance sheets and recognizes its share of the entity's net income or losses in the consolidated statements of income with an offset to the recorded investment on the consolidated balance sheets. Losses are recognized up to the amount of investment recorded.

In addition to voting interests in an entity, a controlling financial interest may also exist in entities through arrangements that do not involve voting interests. The company evaluates entities deemed to be variable interest entities to determine if the company is the "primary beneficiary" under Financial Accounting Standards Board ("FASB") Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). The company implemented the revision of FIN 46, or FIN 46-R, in 2003 and adopted FIN 46-R for 2003 year-end reporting. FIN 46-R provides guidance for determining when a company must consolidate the assets, liabilities and activities of a variable interest entity. If an entity is a variable interest entity, the company must determine if its variable interest is significant and whether the company is the primary beneficiary. Under FIN 46-R, a company is considered the primary beneficiary and must consolidate a variable interest entity when it absorbs a majority of expected losses or expected residual returns, or both. All other entities are evaluated for consolidation under SFAS No. 94, "Consolidation of All Majority-Owned Subsidiaries" ("SFAS 94"). In 2003, no variable interest entities were consolidated in accordance with FIN 46-R. The company has significant variable interests in certain variable interest entities that are not consolidated because the company is not the primary beneficiary. These include certain structured finance transactions, investments in low-income housing tax credit partnerships, and asset backed securitization trusts.

The company consolidates its two majority-owned Real Estate Investment Trusts ("REITs"), Home Ownership Funding Corporation I and Home Ownership Funding Corporation II, and certain other special purpose entity structures. Generally, the company does not use special purpose entities in its credit enhancement and resecuritization transactions. The company also consolidates the accounts of majority-owned West*Mac Associates Limited Partnership, the owner and developer of Freddie Mac's company headquarters, and wholly-owned Ignition Mortgage Technology Solutions, Inc. The equity and net earnings attributable to the minority shareholder interests which relate to the company's consolidated subsidiaries are reported separately in the consolidated balance sheets as Minority interest in consolidated subsidiaries and in the consolidated statements of income as Minority interest in earnings of consolidated subsidiaries, respectively.

The company regularly invests as a limited partner in qualified low-income housing tax credit partnerships that are eligible for federal tax credits. These tax credits are reported as reductions in the company's provision for income taxes pursuant to Emerging Issues Task Force ("EITF") Issue 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects" ("EITF 94-1"). Freddie Mac consolidates those investments over which it has the ability to exercise control and accounts for the non-consolidated investments using the equity method of accounting, in accordance with Statement of Position No. 78-9, "Accounting for Investments in Real Estate Ventures" ("SOP 78-9"). Low-income housing tax credit partnerships created on or after February 1, 2003 were evaluated under FIN 46-R and there was no impact to the consolidated financial statements. Under the transition provisions of FIN 46-R, those partnerships created prior to February 1, 2003 will be evaluated in 2004 and any impact to the consolidated financial statements is not expected to be material. For partnerships accounted for under the equity method, Freddie Mac's recorded investment is reported as part of Other assets and its share of partnership income or

loss is reported in the consolidated statements of income as Non-interest expense — Housing tax credit partnerships. The company's obligations to make delayed equity contributions that are unconditional and legally binding are recorded at their present value in Other liabilities. To the extent the company's cost basis in qualified low income housing tax credit partnerships is different than the book basis reflected at the partnership level, the basis difference is amortized over the life of the tax credits and included in the company's share of earnings (losses) from housing tax credit partnerships. Freddie Mac periodically reviews these investments for impairment and adjusts them to fair value when a decline in market value below the recorded investment is deemed to be "other than temporary" under GAAP. Impairment losses are included in the consolidated statements of income as part of Non-interest expense — Housing tax credit partnerships.

Cash and Cash Equivalents and Statements of Cash Flows

Freddie Mac accounts for highly liquid investment securities with an original maturity of three months or less and used for cash management purposes as cash equivalents. Cash collateral obtained from counterparties to derivative contracts in an unrealized gain position is recorded as Cash and cash equivalents.

In the statements of cash flows, cash flows related to the acquisition and termination of derivatives other than forward commitments are generally classified in investing activities, without regard to whether they are designated as a hedge of another item. Cash flows from commitments accounted for as derivatives under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") that result in the acquisition or sale of mortgage securities or mortgage loans are classified in either (a) investing activities for available-for-sale securities or mortgage loans held for investment or (b) operating activities for trading securities or mortgage loans held for sale. The periodic cash flows on certain derivatives, which are recorded in the consolidated statements of income on an accrual basis either in Income (expense) related to derivatives or in Derivative gains (losses), are reported in operating activities. Cash flows related to guarantee fees, including buy-up payments 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. Cash flows related to mortgage loans classified as held for sale are classified in operating activities unless the loans have been securitized and retained as available-for-sale PCs within the same reporting period, in which case they are classified as investing activities. Cash flows related to the repayment of the original issue discount on short-term, zero-coupon debt are reported as operating activities.

Freddie Mac revised certain amounts from those previously reported on the consolidated statements of cash flows for the years ended December 31, 2002 and 2001. One such revision was made to properly reflect activity related to the Multilender Program (as defined in "Multilender Swap-Based Issuances of PCs" below) which decreased the amounts Freddie Mac previously reported as cash outflows related to the Purchases of held-for-sale mortgages by $81,570 million and $59,962 million for the years ended December 31, 2002 and 2001, respectively, with corresponding decreases in cash inflows related to the Sales of held-for-sale mortgages for those periods. Another revision was made to properly reflect the timing of cash payments between loan servicers and Freddie Mac, which decreased the amounts Freddie Mac previously reported as Proceeds from sales of available-for-sale securities by $3,964 million and $2,195 million for the years ended December 31, 2002 and 2001, respectively, with corresponding increases in Change in accounts and other receivables, net. Also, Freddie Mac revised the amount previously reported as Cash paid for derivative interest carry in 2002 to include $1,127 million related to foreign-currency denominated swaps. Similar amounts related to foreign-currency denominated swaps are included in Cash paid for interest for 2001.

Freddie Mac often retains Structured Securities created through resecuritizations of mortgage-related securities held by the company. The new Structured Securities the company acquires in these transactions are classified as available-for-sale or trading based upon the predominant classification of the mortgage-related security collateral the company contributed. In 2003, there were $322 million of non-cash net transfers to the available-for-sale classification from the trading classification related to resecuritization transactions.

Transfers of Financial Assets that Qualify as Purchases or Sales

Freddie Mac accounts for transfers of financial assets pursuant to the requirements of SFAS No. 140 "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS 140"), and, prior to April 1, 2001, SFAS No. 125 "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS 125"), collectively referred to as "SFAS 125/140." If Freddie Mac determines that it surrenders control over assets that it transfers to a third party, Freddie Mac accounts for such transfers as sales to the extent its counterparty provides consideration other than beneficial interests in the transferred assets (*e.g.*, cash). Likewise, if Freddie Mac determines that it obtains control over assets that were transferred to it, it accounts for such transfers as purchases to the extent Freddie Mac provides consideration other than beneficial interests in exchange for the transferred assets. Freddie Mac accounts for cash-based transfers of financial assets that do not qualify as sales as secured borrowings.

If a transfer of financial assets qualifies as a sale, Freddie Mac continues to carry on its consolidated balance sheets any retained interests in financial assets that were securitized and/or resecuritized. Such retained interests generally take one of two forms. First, in connection with its right to receive guarantee payments (as further discussed below), Freddie Mac recognizes a retained interest that is classified on its consolidated balance sheets as Guarantee asset for Participation Certificates, at fair value. (This retained interest is referred to below as a GA.) Second, Freddie Mac recognizes PCs (or Structured Securities issued by the company using PCs held in its portfolio) that are not transferred to third parties upon the completion of a securitization of mortgage loans (or, in the case of Structured Securities, upon the resecuritization of PCs held in portfolio). PCs and Structured Securities that are held in portfolio are accounted for pursuant to the requirements of SFAS No. 115 "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115"). The carrying amounts of all of such retained interests are 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.

Upon completion of a transfer of financial assets that qualifies as a sale, Freddie Mac also de-recognizes all assets sold and recognizes all assets obtained and liabilities incurred. In this regard, Freddie Mac recognizes the fair value of its recourse obligation to guarantee the payment of principal and interest of PCs and Structured Securities transferred in sale transactions. The initial fair value of such recourse obligations is intended to reflect the estimated amount that Freddie Mac would be required to pay to a third party to be relieved of Freddie Mac's obligations under the guarantee contract. That portion of such recourse obligations that relates to Freddie Mac's non-contingent obligation to stand ready to perform under its guarantee is recognized as Guarantee obligation for Participation Certificates (or as a "GO"), while that portion of such recourse obligations that relates to incurred losses on securitized assets is recognized for consolidated balance sheet purposes as Reserve for guarantee losses on Participation Certificates. Such recourse obligations serve as a reduction of proceeds in the calculation of the corresponding gain (loss) on the sale of transferred PCs and Structured Securities. The fair value of a recognized recourse obligation is estimated using an expected cash flow approach consistent with Statement of Financial Accounting Concepts No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements" ("CON 7"). Such liabilities are valued independently of corresponding GAs. The resulting gain (loss) on sale of transferred PCs and Structured Securities is reflected in Freddie Mac's consolidated statements of income as a component of Gains (losses) on investment activity.

Subsequent Measurement of Recognized GAs — Freddie Mac views recognized GAs as financial assets that can be prepaid or otherwise settled in a manner that may prevent Freddie Mac from recovering substantially all of its recorded investment. As a result, Freddie Mac accounts for GAs like debt instruments classified as trading under SFAS 115. All changes in the fair value of recognized GAs are reflected in earnings as a component of Gains (losses) on "Guarantee asset for Participation Certificates, at fair value." All guarantee-related compensation that is received in cash is reflected in earnings as a component of Management and guarantee income. See "NOTE 2: TRANSFERS OF SECURITIZED INTEREST IN MORTGAGE-RELATED ASSETS" for a discussion of the attribution of GA-related cash flows.

Subsequent Measurement of Recognized GOs — With respect to the subsequent measurement of recognized GOs for the years ended December 31, 2001 and December 31, 2002, Freddie Mac accounts for

recognized GOs at fair value. All changes in fair value are reflected in Freddie Mac's consolidated financial statements of income as a component of Income (expense) on "Guarantee obligation for Participation Certificates."

With respect to the subsequent measurement of recognized GOs for the year ended December 31, 2003, Freddie Mac subsequently measures such liabilities using a systematic and rational method of amortization. More specifically, Freddie Mac amortizes recognized GOs into earnings in proportion to the rate of unpaid principal balance decline of securitized mortgage loans. Periodic amortization of recognized GOs is reflected in earnings as a component of "Income (expense) on Guarantee obligation for Participation Certificates." Freddie Mac subsequently measures its contingent obligation to make guarantee payments pursuant to the provisions of SFAS 5. See discussion below in "Recently Adopted Accounting Standards and Accounting Changes" for further discussion concerning the change in methods used by Freddie Mac to subsequently measure recognized GOs.

Guarantor Swap Transactions Executed Prior to January 1, 2003

Guarantor Swaps represent transactions in which third party institutions transfer mortgage loans to Freddie Mac in exchange for issued PCs that are backed by such mortgage loans. In return for providing its guarantee on such issued PCs, and similar to PCs described above in "Transfers of Financial Assets that Qualify as Purchases or Sales," Freddie Mac earns a management and guarantee fee ("Required G-Fee") that is paid to Freddie Mac over the life of an issued PC. It is also common for buy-up or buy-down payments ("Buy-Ups" or "Buy-Downs," respectively) to be exchanged between Freddie Mac and its counterparties upon the issuance of a PC. Buy-Ups represent upfront payments that are made by Freddie Mac, which increase the Required G-Fee that Freddie Mac will receive over the life of the PC in connection with its guarantee. Buy-Downs represent upfront payments that are made to Freddie Mac, which decrease (*i.e.*, partially prepay) the Required G-Fee that Freddie Mac will receive over the life of the PC in connection with its guarantee. Moreover, Freddie Mac occasionally receives upfront, cash-based payments as additional compensation for its guarantee of mortgage loans with certain credit risk related characteristics ("Credit Fees"). Finally, and as additional consideration received on such exchanges, Freddie Mac receives various types of seller-provided credit enhancements that correspond to securitized mortgage loans. The accounting for the primary components of Guarantor Swaps executed prior to January 1, 2003 follows.

Accounting For Guarantee Fees, Buy-Up, Buy Down and Credit Fees — Required G-Fees (as adjusted for Buy-Down payments received) are recognized as Management and guarantee income on an accrual basis over the corresponding guarantee period in accordance with the provisions of EITF Issue No. 85-20, "Recognition of Fees for Guaranteeing a Loan."

Buy-Up amounts paid at PC issuance are recognized on the consolidated balance sheets as a GA if the corresponding PCs are held by third parties and are accounted for like a debt security that is classified as trading under SFAS 115. If a Buy-Up was paid in connection with PCs that Freddie Mac holds, the Buy-Up is recognized as a component of Participation Certificate Residual (discussed further below).

Buy-Down and Credit Fee amounts that are received at PC issuance are deferred on Freddie Mac's consolidated balance sheets as an adjustment of Other liabilities. These amounts are amortized into Management and guarantee income pursuant to the requirements of SFAS No. 91. "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases" ("SFAS 91").

If Freddie Mac were to purchase and then subsequently sell for GAAP purposes a PC that was issued prior to January 1, 2003 as part of a Guarantor Swap (and for which a GA and GO were never previously recognized), it would recognize as a GA the fair value of its contractual right to receive guarantee fees, and would also recognize as a GO the fair value of its obligation to guarantee the payment of principal and interest on such securities. Such assets and liabilities would be subsequently measured in a manner that is consistent with principles described above in "Transfers of Financial Assets that Qualify as Purchases or Sales."

Accounting For Guarantee Obligations — Freddie Mac measures its contingent obligation to make guarantee payments pursuant to the provisions of SFAS 5.

Accounting For Credit Enhancements — Premium payments on purchased pool insurance are recognized as Other Assets, which are amortized into non-interest expenses (a) on a straight-line basis over three-month periods to the extent that premiums paid were quarterly-based, and (b) on a level yield basis to the extent that Freddie Mac paid related pool insurance premiums upfront and in full. Otherwise, credit enhancements do not receive recognition at the inception of executed Guarantor Swap transactions.

To the extent that related PCs that correspond to received credit enhancements (and for which a GA and GO were never previously recognized) are purchased and then subsequently sold for GAAP purposes by Freddie Mac, the fair value of received pool insurance or recourse is recognized as a component of GAs, while the fair value of primary mortgage insurance ("PMI") is recognized as a component of GOs. Such amounts are subsequently measured in a manner that is consistent with principles described above in "Transfers of Financial Assets that Qualify as Purchases or Sales."

Guarantor Swap Transactions Executed on or after January 1, 2003

Freddie Mac accounts for Guarantor Swaps that were executed on or after January 1, 2003 pursuant to the requirements of FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). As exchange transactions, executed Guarantor Swap transactions are recognized by Freddie Mac at the inception of such transactions on a fair value basis. The accounting for each of the components of Guarantor Swap transactions executed on or after January 1, 2003 follows.

Accounting For Guarantee Fees — As consideration received in connection with a guarantee-related exchange transaction, Freddie Mac recognizes the fair value of its contractual right to receive guarantee fees as a GA at the inception of an executed guarantee. Consistent with principles described above, such assets, which are classified as Guarantee asset for Participation Certificates, at fair value, are subsequently measured on a fair value basis. All changes in the fair value of recognized GAs are reflected in earnings as a component of Gains (losses) on "Guarantee asset for Participation Certificates, at fair value." All guarantee-related compensation that is received in cash is reflected in earnings as a component of Management and guarantee income.

Accounting For Guarantee Obligations — GOs are initially measured as the greater of (a) fair value or (b) the contingent liability amount required by SFAS 5 to be recognized at inception of an executed guarantee. The fair value of a recognized GO is estimated using an expected cash flow approach consistent with CON 7. Such liabilities are valued independently of corresponding GAs that are recognized in connection with such transactions. That portion of Freddie Mac's estimated guarantee liability that relates to its non-contingent obligation to stand ready to perform under a PC guarantee is recognized as Guarantee obligation for Participation Certificates, while that portion of its estimated guarantee liability that relates to its contingent obligation to make payments under its guarantee is recognized for balance sheet purposes as "Reserve for guarantee losses on Participation Certificates."

Freddie Mac subsequently measures recognized GOs by amortizing such liabilities into earnings in proportion to the rate of the unpaid principal balance decline of securitized mortgage loans. Periodic amortization of recognized GOs is reflected in earnings as a component of Income (expense) on "Guarantee obligation for Participation Certificates." Freddie Mac subsequently measures its contingent obligation to make guarantee payments pursuant to the provisions of SFAS 5.

Accounting For Credit Enhancements — With respect to those credit enhancements that are received in connection with Guarantor Swaps and other similar exchange transactions of PCs:

- Pool insurance is recognized as an Other asset at its fair value;
- Recourse and/or indemnifications that are provided by counterparties to Guarantor Swap transactions are recognized at fair value as Other assets; and
- PMI is recognized at inception at fair value as a component of recognized GOs.

Credit enhancements that are separately recognized as Other assets are amortized into earnings as Non-interest expense. Such assets are specifically amortized over related contract terms at the greater of results calculated by amortizing recognized credit enhancements (a) in proportion to the rate of unpaid principal

balance decline of covered mortgage loans or (b) on a straight-line basis over a credit enhancement's contract term.

Accounting For Inception Differences Between Consideration Received and Guarantee Obligations Incurred — Because GAs, GOs and credit enhancement-related assets that are recognized at the inception of an executed Guarantor Swap are valued independently of each other, net differences between such recognized assets and liabilities may exist at inception. Net positive differences between such amounts, which are hereinafter referred to as "Day One Differences," are deferred on Freddie Mac's consolidated balance sheet as a component of Guarantee obligation for Participation Certificates. Net negative differences between GAs, GOs and credit enhancement-related assets that are recognized at the inception of executed financial guarantees are expensed immediately to earnings as a component of Other expenses.

Day One Differences are amortized into earnings at a rate that is commensurate with the observed decline in the unpaid principal balance of securitized mortgage loans. Period amortization of recognized Day One Differences is reflected in earnings as a component of Income (expense) on "Guarantee obligation for Participation Certificates."

Accounting For Buy-Ups, Buy-Downs and Credit Fees — Cash payments that are made or received in connection with Buy-Ups and Buy-Downs are recognized as adjustments of recognized Day One Differences. Likewise, Credit Fees that are received at inception are also recognized as adjustments of recognized Day One Differences.

MultiLender Swap-Based Issuances of PCs

Freddie Mac issues PCs through its MultiLender Program that are backed by mortgage loans delivered to Freddie Mac by more than one third party. Freddie Mac may itself contribute mortgage loans to Multilender pools from which PCs are then issued and delivered to third parties (and to Freddie Mac, to the extent that it contributed mortgage loans to a Multilender pool). Freddie Mac accounts for its contributions of mortgage loans to a Multilender pool as partial sales of those assets, the sold portion of which is dependent upon the contribution of collateral made by Freddie Mac relative to third parties. The portion of a MultiLender Swap transaction that qualifies as a sale is accounted for in the same manner as transfers described above that are accounted for as sales. The remaining portion of such PC issuances and transfers are accounted for in a manner consistent with the accounting for PCs issued through the Guarantor Program (as described above).

PC-for-Structured Security Swap Transactions

Freddie Mac issues and transfers Structured Securities to third parties in exchange for PCs and non-Freddie Mac mortgage-related securities. Freddie Mac cannot freely pledge or exchange the securities that are delivered to it by third parties in these exchanges. As a result, Freddie Mac does not view such exchanges as triggering sale accounting recognition under SFAS 125/140. Additionally, Freddie Mac does not account for such exchanges pursuant to the requirements of FIN 45. As a result, Freddie Mac does not recognize any incremental GAs or GOs on such transactions. Rather, Freddie Mac defers and amortizes into income on a straight-line basis that portion of the transaction fee that Freddie Mac receives on such transactions, that relates to the estimated fair value of the company's future administrative responsibilities for issued Structured Securities. In cases where Freddie Mac retains portions of the Structured Securities, a portion of this fee is deferred under the requirements of SFAS 91. The balance of transaction fees received, which relates to compensation earned in connection with structuring-related services rendered by Freddie Mac to third parties, is recognized immediately into "Resecuritization fees."

Purchases of PCs or Structured Securities for Which Recognized GAs and GOs Exist

The purchase of a PC or Structured Security prompts the extinguishment of a corresponding, recognized GO. Likewise, and where applicable, the purchase of such securities also prompts the extinguishment of the unamortized balance of deferred Day One Differences, Buy Downs and Credit Fees.

Freddie Mac records the de-recognition of an extinguished GO against earnings as a component of Gains (losses) on investment activity. Correspondingly, recognized GAs are reduced by an amount equal to the-then fair value of an extinguished GO, an adjustment of which is also reflected in earnings as a component of Gains

(losses) on investment activity. All recognized GAs in this case are then reclassified on Freddie Mac's consolidated balance sheets as a component of "Participation Certificate residuals, at fair value."

The unamortized balance of deferred Day One Differences, Buy-Downs and Credit Fees received are extinguished as a basis adjustment to the recognized value of purchased PCs. Like purchase discounts, such basis adjustments are subsequently amortized into earnings as Interest income pursuant to the requirements of SFAS 91.

PC Residuals

PC residuals relate to certain PCs or Structured Securities held by Freddie Mac and represent the fair value of the expected future cash flows associated with the guarantee contracts that are inherent within such securities.

A PC residual is recognized by Freddie Mac in connection with PCs or Structured Securities held by Freddie Mac that (a) were previously transferred to third parties as part of transactions that were accounted for either as sales pursuant to the provisions of SFAS 125/140 sale or as guarantee transactions that are subject to the provisions of FIN 45 (such that a GA and GO was previously-established for held PCs or Structured Securities), (b) were formed from Cash Window Purchases and that were never transferred to third parties, (c) were purchased by Freddie Mac from third parties in contemplation of the related issuance of such PCs through the Guarantor Program and (d) relate to buy-ups paid in connection with purchased PCs that had not previously been included as part of a transfer that was accounted for as a sale under SFAS 125/140 or as part of a guarantee transaction that was subject to the provisions of FIN 45.

Like a recognized GA, a PC residual is accounted for like a debt security and is classified as either available for sale or trading under SFAS 115. PC residuals relating to PCs or Structured Securities that previously went through either a SFAS 125/140 sale or were accounted for pursuant to FIN 45 are classified as trading under SFAS 115. PC residuals relating to PCs held in portfolio that were formed from Cash Window Purchases and that were never transferred to third parties are accounted for like debt investments and generally are classified as available for sale under SFAS 115. The same treatment applies to PC residuals that correspond to PCs purchased by Freddie Mac from third parties in contemplation of their issuance through the Guarantor Program, except that any portions of these PC residuals that relate to Buy-Ups paid by Freddie Mac are accounted for as trading investments.

All changes in the fair value of PC residuals that are designated as trading are reflected in earnings as a component of Gains (losses) on investment activity. All changes in the fair value of PC residuals that are accounted for as available-for-sale are reflected as a component of Accumulated other comprehensive income (loss), net of taxes ("AOCI").

Recognized PC residuals consist of a variety of cash flows that are primarily recorded through interest income. See "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" for a discussion of the attribution of GA and PC residual-related cash flows.

Due to Participation Certificate Investors

Timing differences between Freddie Mac's receipt of scheduled and unscheduled principal and interest payments from seller/servicers on mortgages underlying PCs and the subsequent pass through of those payments on PCs owned by third party investors results in the liability Due to Participation Certificate investors. In those cases, payments from seller/servicers are generally received in a given month, yet the PC balance is not reduced for payments of principal until the first day of the next month, and Freddie Mac releases the cash (principal and interest) to the PC investor on the fifteenth day of that next month. The company generally invests these principal and interest amounts received in short-term investments from the time Freddie Mac receives the amounts until the time Freddie Mac pays the PC investor. Interest income resulting from investment of principal and interest payments from seller/servicers is reported in interest income over the period earned.

For unscheduled principal prepayment amounts, these timing differences result in an expense accrual upon prepayment of the mortgage as the related PCs continue to bear interest to the PC investor at the PC coupon rate from the date of prepayment until the date the PC security balance is reduced, while generally no

interest is received from the mortgage on that prepayment amount during that same time period. The expense recognized upon prepayment is reported in Interest expense — Due to Participation Certificate investors.

Freddie Mac reports PC coupon interest amounts relating to its investment in PCs consistent with the accounting practices generally applied by third party investors in PCs. Accordingly, the PC coupon interest on prepayments of a mortgage pending remittance on PCs held by Freddie Mac is reported as both Interest Income-Mortgage-related securities in the Retained portfolio and Interest expense — Due to Participation Certificate investors. Scheduled and unscheduled principal payments received by Freddie Mac that relate to its investment in PCs are reported as a reduction to its investment in PCs on the consolidated balance sheets.

Mortgage Loans

Mortgage loans that management may sell are classified as held for sale. When the decision is made to retain the loan, the loans are transferred to the "held-for-investment" portfolio. Loans transferred to the held-for-investment portfolio are transferred at lower of cost or market value. Lower of cost or market value adjustments, in this case, are treated as basis adjustments of such mortgage loans and are subsequently amortized into interest income over the period held.

Held-for-sale mortgages are included in the Retained portfolio and reported at lower of cost or market value, on a portfolio basis, with losses reported in Gains (losses) on investment activity. Consistent with SFAS No. 65, "Accounting for Certain Mortgage Banking Activities" ("SFAS 65"), premiums and discounts on loans classified as held for sale are not amortized as interest revenue during the period that such loans are classified as held for sale.

Freddie Mac determines the fair value of held-for-sale mortgage loans based on comparisons to actively traded mortgage-backed securities with similar characteristics, with an adjustment for credit and liquidity, as discussed below, related to an implied guarantee fee. Specifically, Freddie Mac aggregates mortgage loans into pools by product type, coupon and maturity and then converts the pools into notional mortgage-backed securities based on their specific characteristics. Freddie Mac then calculates fair values for these notional mortgage-backed securities using the process that is described in "Securities" below. The fair value of the whole loans also includes an adjustment representing the additional cash flows on the mortgage coupon of the whole loan in excess of the coupon expected on the notional mortgage-backed securities. This adjustment is net of the related credit and other guarantee obligation components.

Mortgage loans that management has the ability and intent to hold for the foreseeable future or to maturity are classified as held for investment. These mortgage loans are reported at their outstanding principal balances, net of deferred fees and costs (including premiums and discounts). These deferred items are amortized into interest income over the estimated lives of the mortgages using the effective interest method. The company uses 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.

The company recognizes interest income on mortgage loans on an accrual basis, except when management believes the collection of principal or interest is doubtful.

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

Freddie Mac maintains a Reserve for losses on mortgage loans held for investment to provide for credit losses inherent in that portfolio. The Reserve for losses on mortgage loans held for investment is determined pursuant to the provisions of SFAS 5 and SFAS No. 114, "Accounting by Creditors for Impairment of a Loan — an Amendment of FASB Statements No. 5 and 15" ("SFAS 114") as more fully described below. Freddie Mac also maintains a Reserve for guarantee losses on Participation Certificates to provide for losses incurred on mortgages underlying PCs or Structured Securities held by third parties. The Reserve for guarantee losses on Participation Certificates is determined pursuant to the provisions of SFAS 5. The Reserve for losses on mortgage loans held for investment and Reserve for guarantee losses on Participation Certificates are, for the purpose of this NOTE 1 to the financial statements, collectively referred to as loan loss reserves. Increases in loan loss reserves are reflected in earnings as a component of the Provision for credit losses. Decreases in loan loss reserves are reflected through either (a) charging-off such balances (net of recoveries) where realized losses are recorded or (b) a reduction in the Provision for credit losses.

Loan loss reserves are also increased upon the sale of PCs and Structured Securities for which Freddie Mac incurred losses on the underlying mortgage loans while such securities were held by Freddie Mac. From an earnings perspective, such incurred losses are classified as a component of Gains (losses) on investment activity. In this regard, and upon the sale of such PCs or Structured Securities, incurred losses are classified on the consolidated balance sheets as Reserve for guarantee losses on Participation Certificates.

Single-family loan portfolio

In accordance with SFAS 5, Freddie Mac estimates incurred credit losses on homogeneous pools of single-family loans using statistically-based models that evaluate a variety of factors, resulting in a range of probable losses related to impaired single-family loans at the balance sheet date. The homogeneous pools of single-family loans are determined based on common underlying characteristics including book year, loan-to-value ratio and geographic region. The factors used to estimate incurred losses as of period-end include: actual and estimated loss severity trends for similar loans; actual and estimated default experience; actual and estimated proceeds from private mortgage insurance and other credit enhancements; actual and estimated pre-foreclosure real estate taxes and insurance; the year of the loan origination; geographic location; and estimated selling costs should the underlying property ultimately be foreclosed upon and sold. Freddie Mac frequently validates and updates the models and factors to capture changes in actual loss experience, as well as changes in underwriting practices and in its loss mitigation strategies.

In determining the loan loss reserves for single-family loans, Freddie Mac establishes a range of probable losses and determines the point within the range that represents the best estimate of incurred losses. Freddie Mac also considers macroeconomic factors, including regional housing trends, applicable home price indices, unemployment and employment dislocation trends, consumer credit statistics, recent changes in credit underwriting practices, extent of third party insurance, and other measurable factors that influence the quality of the portfolio at the balance sheet date. Favorable trends in these macroeconomic factors produce a reserve requirement toward the lower end of the range; adverse trends in these macroeconomic factors produce a reserve requirement toward the higher end of the range. Management then adjusts the level of loan loss reserves to the level required based on its best assessment of these macroeconomic factors.

Multifamily loan portfolio

Freddie Mac also estimates a range of incurred credit losses on the multifamily loan portfolio. Factors considered in determining this range include: adequacy of third party credit enhancements and an evaluation of the repayment prospects of, and value of collateral underlying, individual loans. The review of the repayment prospects and value of collateral underlying individual loans occurs within the context of property-specific and market-level risk characteristics including apartment vacancy rates, apartment rental rates, and property sales information, under several scenarios. Management reviews the range of probable losses and selects the point within the range that represents the best estimate of incurred losses. Loans individually evaluated for impairment include loans that become 60 days past due for principal and interest, certain loans with observable collateral deficiencies, and loans whose contractual terms were modified due to credit concerns. When loan loss reserves for individual loans are established, consideration is given to all available evidence such as present value of discounted expected future cash flows, fair value of collateral and credit enhancements.

Non-performing Loans

Non-performing loans are comprised of (a) loans that were previously delinquent whose terms have been modified ("troubled debt restructurings" or "TDRs"), (b) serious delinquencies, and (c) nonaccrual loans. Serious delinquencies are those single-family loans that are 90 days or more past due, and multifamily loans that are more than 60 days but less than 90 days past due. Also included in this category are multifamily loans greater than 90 days past due but where principal and interest are being paid to us under the terms of a credit enhancement agreement. Non-performing loans generally accrue interest in accordance with their contractual terms unless they are in nonaccrual status. Nonaccrual loans are loans where interest income is recognized on a cash basis, and only includes multifamily loans greater than 90 days past due. For nonaccrual loans any existing accruals are reversed against interest income unless they are both well secured and in the process of collection. For single-family loans greater than 90 days past due interest income is accrued; however, reserves

for uncollectible interest on single-family loans are estimated using statistical models, which quantify accrued but uncollectible interest at the consolidated balance sheet date. Freddie Mac reports this reserve as a reduction to the accrued loan interest balance in Accounts and other receivables, net.

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

Freddie Mac has the option to purchase mortgage loans out of PC pools under certain circumstances, such as to resolve an existing or impending delinquency or default. Freddie Mac's general practice is to purchase the mortgage loans out of pools when the loans are 120 days delinquent. These repurchased loans are recorded on Freddie Mac's consolidated balance sheets at their purchase price (*i.e.*, the mortgage loan's unpaid principal balance), as adjusted for the effects of (a) the related amount of recognized GAs, PC residuals and security premiums and discounts (where applicable), and (b) the extinguishment of a proportionally related amount of recognized Buy-Downs, Credit Fees, GOs and Day One Differences (where applicable). Additionally, that portion of amounts classified in Reserve for guarantee losses on Participation Certificates that relates to a purchased loan is reclassified to Reserve for losses on mortgage loans held for investment.

Charge-Offs

Amounts are charged-off when a loss is specifically identified and is virtually certain of occurring. For both single-family and multifamily mortgages where the original terms of the agreement are modified for economic or legal reasons related to the borrower's financial difficulties, losses are recorded at the time of modification in accordance with SFAS 114 and the loans are accounted for as TDRs. For mortgages that are foreclosed upon and thus transferred to Real estate owned, net or involved in a pre-foreclosure sale, losses at the time of transfer or pre-foreclosure sale are charged-off against Reserve for losses on mortgage loans held for investment. In the case of real estate owned ("REO") transfers, losses arise when the carrying basis of the loan (including accrued interest) exceeds the fair value of the foreclosed property (after deduction for estimated selling costs and consideration of third party insurance or other credit enhancements). REO gains arise when the fair market value of the acquired asset (after deduction for estimated disposition costs and consideration of third party insurance or other credit enhancements) exceeds the carrying value of the mortgage (including accrued interest). REO gains and losses are included in REO operations income (expense).

Securities

The company classifies mortgage-related securities and non-mortgage securities as available for sale or trading, as defined in SFAS 115. The company was not permitted to classify securities as held to maturity, as defined in SFAS 115, due to inappropriate sales in 2001. The company is currently evaluating whether it will classify securities as held to maturity in the future. Securities classified as available for sale and trading are reported at fair value with changes in fair value included in AOCI and Gains (losses) on investment activity, respectively. Mortgage-related securities are recorded as part of the Retained portfolio except when they are purchased to support Freddie Mac's PC market-making and support activities, in which case they are recorded as part of Investments.

The fair value of securities with readily available third-party market prices is generally based on market prices obtained from brokers and dealers, reliable third-party pricing service providers or direct market observations. Fair value may be estimated by using third-party quotes for similar instruments, adjusted for differences in contractual terms. For other securities, a market option-adjusted spread approach is used to estimate fair value. This option-adjusted spread approach uses a model developed from market data and management judgment. Option-adjusted spreads for certain securities are estimated by deriving the option-adjusted spread for the most closely comparable security with an available market price, using interest-rate and prepayment models. If necessary, management judgment is applied to estimate the impact of differences in prepayment uncertainty or other unique cash flow characteristics related to that particular security. Fair values for these securities are then estimated by using the estimated option-adjusted spread as an input to the

interest-rate and prepayment models, and estimating the net present value of the projected cash flows. The remaining instruments are priced using other modeling techniques or by using other securities as proxies.

Effective January 1, 2002, Freddie Mac began recognizing the financial statement effects of nonderivative forward purchases and sales of securities on a trade date basis. Such accounting is required under SOP No. 01-6, "Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others" ("SOP 01-6"), when the purchase and sale commitments are not accounted for as derivatives. Under trade date accounting, forward purchases and sales are recorded as an increase or decrease to the security account on the trade date, with a corresponding increase to Other liabilities or Accounts and other receivables, net, respectively. In the case of sales, the gain or loss is also recognized on the trade date. Prior to January 1, 2002, Freddie Mac recorded all security transactions on the settlement date. For non-derivative forward purchase commitments, accounting between trade date and settlement date was recorded pursuant to EITF No. 96-11, "Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115" ("EITF 96-11"). EITF 96-11 requires that changes in the fair value of commitments to acquire available-for-sale securities be recorded through AOCI, net of taxes and changes in the fair value of commitments to acquire trading securities be recorded through earnings. The cumulative effect of transitioning from settlement date to trade date accounting was not material to the financial statements.

For most of the company's investments in securities, interest income is recognized using the retrospective effective interest method in accordance with SFAS 91. Deferred items, including premiums, discounts and other basis adjustments, are amortized into interest income over the estimated lives of the securities. The company uses actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method. In estimating future prepayments and cash flows, the company aggregates securities with similar characteristics of their underlying collateral such as origination date, coupon and maturity. For Structured Securities, estimates of future prepayments and cash flows also consider the characteristics of other security classes within the same structure. The company recalculates the constant effective yield based on changes in estimated prepayments as a result of changes in interest rates and other factors and actual prepayments versus anticipated prepayments. When the constant effective yield changes, an adjustment to interest income is made for the amount of premium and discount amortization that would have been recorded if the new effective yield had been applied since the mortgage assets were acquired.

For certain of the company's investments in securities, interest income is recognized using the prospective effective interest method in accordance with EITF No. 99-20 "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets" ("EITF 99-20"). The company specifically applies such guidance to beneficial interests (including undivided interests which are similar to beneficial interests) in securitized financial assets that (a) can contractually be prepaid or otherwise settled in such a way that the company may not recover substantially all of its recorded investment (such as interest-only strips) or (b) are not of high credit quality at the acquisition date. EITF 99-20 requires that the company recognize as interest income (throughout the life of a retained interest) the excess of all estimated cash flows attributable to these interests over its principal amount using the effective yield method. The company updates its estimates of expected cash flows periodically and recognizes changes in calculated effective yield on a prospective basis. Prior to the company's implementation of EITF 99-20 on April 1, 2001, the company recognized interest income for interest-only strips on the prospective effective interest method in accordance with EITF No. 89-4, "Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate" ("EITF 89-4").

Freddie Mac reviews securities for other-than-temporary impairment when a security meets one or more of a series of objective criteria relative to its fair value compared to its amortized cost, credit ratings, the amount of time the investment has been in an unrealized loss position, or if the company otherwise believes that an unrealized loss is other than temporary based on qualitative indicators of potential impairment. Impairment losses on manufactured housing securities exclude the effects of separate financial guarantee contracts that are not embedded in the securities since the benefits of such contracts are not recognized until claims become probable of recovery under the contracts. When a security is deemed to be impaired, the cost

basis of the security is written down to fair value, with the loss recorded to Gains (losses) on investment activity. The security cost basis is not changed for subsequent recoveries in fair value.

For securities within the scope of EITF 99-20, as described above, other-than-temporary impairments are defined as occurring whenever there is an adverse change in estimated cash flows coupled with a decline in fair value below the amortized cost basis. Prior to the company's implementation of EITF 99-20, other-than temporary impairment for such securities was defined under SFAS 115 or EITF No. 93-18, "Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Investment or in a Mortgage-Backed Interest-Only Certificate" ("EITF 93-18"), as applicable.

Gains and losses on the sale of securities are included in Gains (losses) on investment activity. The company uses the specific identification method for determining the cost of a security in computing the gain or loss.

Repurchase and Resale Agreements

Freddie Mac enters into repurchase and resale agreements primarily as an investor or to finance its security positions. Freddie Mac also enters into (a) "dollar roll" transactions, which consist of simultaneous agreements with the same counterparty to sell a security and purchase similar securities at a future date at an agreed-upon price and (b) "reverse dollar roll" transactions, which consist of simultaneous agreements with the same counterparty to purchase a security and sell similar securities at a future date at an agreed-upon price. These transactions are accounted for as financings when the sale criteria of SFAS 125/140 are not satisfied. Freddie Mac's policy is to take possession of securities purchased under agreements to resell and reverse dollar roll transactions. The amount of mortgage-related and non-mortgage-related securities pledged (that may be repledged) under repurchase agreements and dollar roll transactions is presented parenthetically in the relevant securities captions in the consolidated balance sheets.

Debt Securities

Debt securities are classified as either Due within one year or Due after one year based on their remaining contractual maturity. The classification of interest expense on debt securities as either short-term or long-term is based on the original contractual maturity of the debt security. Deferred items, including premiums, discounts, issuance costs and hedging-related basis adjustments, are amortized and reported through interest expense using the effective interest method over the period during which the related indebtedness is outstanding or, for callable debt, over the period during which the related indebtedness is expected to be outstanding. For callable debt, changes in the expected call date are reflected prospectively as an adjustment to the effective yield on the debt. Amortization of hedging-related basis adjustments is initiated upon the termination of the related hedge relationship whereas amortization of premiums, discounts and issuance costs begins at the time of debt issuance. Deferred items, including premiums, discounts and hedging-related basis adjustments are reported as a component of Debt securities, net whereas issuance costs are reported as a component of Other assets. Debt securities denominated in a foreign currency are translated into U.S. dollars using foreign exchange spot rates as of the balance sheet date. The company uses foreign currency swaps to hedge against the risk of changes in foreign currency exchange rates.

Contemporaneous exchanges of cash between the company and a creditor in connection with the issuance of a new debt obligation and satisfaction of an existing debt obligation are accounted for as extinguishments if the debt instruments have substantially different terms, as defined by EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments." If the debt instruments do not have substantially different terms, the transaction is accounted for as an exchange rather than an extinguishment and the fees associated with the new debt obligation, along with the existing unamortized premium or discount on the existing debt obligation, are considered 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.

Derivatives

Generally, derivatives are financial instruments with little or no initial net investment in comparison to their notional amount and whose value is based upon an underlying asset, index, reference rate or other variable. Over-the-counter derivatives are privately negotiated contractual agreements that can be customized to meet specific needs. This includes certain commitments to purchase and sell mortgage loans, mortgage-

related securities, and debt securities. Exchange-traded derivatives are standardized contracts executed through organized exchanges. The fair value of derivatives is generally reported net by counterparty, provided that a legally enforceable master netting agreement exists. Derivatives in a net asset position are reported as "Derivative assets, at fair value." Similarly, derivatives in a net liability position are reported as "Derivative liabilities, at fair value."

A significant portion of the company's derivative portfolio is not designated in hedge accounting relationships. For those derivatives not qualifying as an accounting hedge, fair value gains and losses are reported as "Derivative gains (losses)" in the consolidated statements of income. For purchase and sale commitments of securities classified as trading under SFAS 115, fair value gains and losses are reported as "Gains (losses) on investment activity" in the consolidated statements of income.

Subject to certain qualifying conditions, Freddie Mac may designate a derivative as either a hedge of the cash flows of a variable-rate instrument or forecasted transaction ("cash flow hedge"), a hedge of the fair value of a fixed-rate instrument ("fair value hedge"), or a foreign-currency fair value or cash flow hedge ("foreign currency hedge"). In order to be designated as an accounting hedge, the derivative must be highly effective in offsetting the changes in cash flows or fair value of the hedged item resulting from the hedged risk. In addition, the documentation of the hedging designation must include identification of the hedged item, the hedging instrument, the risk exposure and corresponding risk management objective and how effectiveness will be assessed.

For a derivative qualifying as a cash flow hedge, Freddie Mac reports changes in the fair value of these instruments in a separate component of AOCI to the extent the hedge is effective. The remaining ineffective portion, calculated using the hypothetical derivative method, is reported as Hedge accounting gains (losses). This method requires us to develop a hypothetical derivative whose terms match those of the hedged item and compare those of the hedged item and compare estimated changes in it to changes in the hedging derivative. Freddie Mac recognizes the effective portion of the cumulative changes in fair value as Income (expense) related to derivatives during the period(s) in which the hedged item affects earnings, unless (a) occurrence of the forecasted transaction is probable of not occurring, in which case the amount in AOCI is reclassified to earnings immediately, (b) Freddie Mac expects at any time that continued reporting of a net loss in AOCI would lead to recognizing a net loss on the combination of a hedging instrument and the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, in which case a loss shall be reclassified immediately into earnings for the amount that is not expected to be recovered, or (c) the occurrence of the forecasted transaction was the issuance of long-term debt; in which case, Freddie Mac recognizes the effective portion of the cumulative changes in fair value as Long-term debt interest expense. The effective portion of the cumulative changes in fair value associated with purchase and sale commitments that are accounted for as derivatives in cash flow hedge relationships is recognized as interest income for assets held and Gains (losses) on investment activity for assets sold. For a derivative qualifying as a fair value hedge, Freddie Mac reports changes in the fair value of the derivative as Hedge accounting gains (losses) along with the changes in the fair value of the hedged item attributable to the risk being hedged. When the hedge is terminated or redesignated, the fair value adjustment to the carrying amount of the hedged asset or liability is amortized to earnings as a component of the hedged item's interest income or expense over the remaining life of the hedged item using the effective yield method.

If a derivative no longer qualifies as a cash flow or fair value hedge, the company discontinues hedge accounting prospectively. Freddie Mac continues to carry the derivative on the consolidated balance sheets at fair value and records further fair value gains and losses in the consolidated statements of income as "Derivative gains (losses)" until the derivative is terminated or redesignated.

For any component of a derivative that is excluded from hedge effectiveness assessment, Freddie Mac reports fair value gains and losses as Income (expense) related to derivatives. The periodic interest cash flows related to derivatives contracts currently accrued, which is derived primarily from interest-rate swap contracts, is classified as Income (expense) related to derivatives for derivatives in hedge relationships and as Derivative gains (losses) for derivatives not in hedge accounting relationships. In September 2003, the Office of the Chief Accountant of the Securities and Exchange Commission ("SEC") published interpretive guidance on SFAS 133. The SEC view requires the income statement effects of derivatives not currently designated in hedge accounting relationships under SFAS 133 to be reported in a single line item. Freddie Mac includes

these income statement effects in Derivative gains (losses) for all periods presented. Prior to 2003, the accrual for periodic cash settlements in accordance with the contractual terms of derivatives not in hedge accounting relationships was recorded in net interest income as a component of Income (expense) related to derivatives. Therefore, for periods prior to 2003, the impact of the accrual for these periodic derivative cash settlements has been reclassified from Income (expense) related to derivatives to Derivative gains (losses). The effect of this reclassification on Freddie Mac's consolidated statements of income was to increase Net interest income by $639 million and $456 million for 2002 and 2001, respectively, and decrease Non-interest income by the same amounts.

Inception gains or losses associated with commitments to purchase mortgage loans are deferred. With respect to those purchase commitments that have been designated as cash flow hedges, inception gains or losses are considered together with that portion of the cumulative change in fair value of such derivative instruments that are recognized in AOCI for the purpose of determining whether a net deferred loss exists that, as described above, should be reclassified to earnings. Additionally, and similar to derivative-related gains that are recognized as a component of AOCI, deferred inception-based gains on mortgage purchase commitments will be reclassified into earnings in the same period or periods during which acquired mortgage loans affect earnings. Specifically, inception gains or losses are:

- Recognized as a component of the gain or loss on sale of corresponding mortgage loans (either in whole loan or securitized form); or
- Recognized as interest income over the life of the corresponding mortgage loans at the point that, where applicable, such mortgage loans are reclassified as held-for-investment.

Real Estate Owned ("REO")

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

Income Taxes

Freddie Mac uses the asset and liability method of accounting for income taxes pursuant to SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109"). Under the asset and liability 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 management. Reserves are recorded for income tax and contingent interest where the potential for loss is probable and reasonably estimable in accordance with SFAS 5.

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

Stock-Based Compensation

In December 2002, FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure — An Amendment of FASB Statement No. 123" ("SFAS 148"). This statement

provides alternative methods of transition for a voluntary change to the fair value expense recognition method of accounting for stock-based employee compensation under SFAS No. 123 "Accounting for Stock-Based Compensation" ("SFAS 123"). The annual disclosure provisions of SFAS 148 are effective for fiscal years ending after December 15, 2002, and the interim disclosure provisions are effective for interim periods beginning after December 15, 2002.

Freddie Mac initially adopted the fair value compensation expense provisions of SFAS 123 prospectively for awards granted, modified, or settled on or after January 1, 2002, in accordance with SFAS 123's original transition provision. However, Freddie Mac has elected to adopt SFAS 123 retroactively to January 1, 1995 as permitted by SFAS 148. Accordingly, Freddie Mac records compensation expense equal to the estimated fair value of the stock-based compensation on the grant date, amortized on a straight-line basis over the vesting period, which is generally three to five years for options, restricted stock and restricted stock units and, starting in 2003, three months for the Employee Stock Purchase Plan ("ESPP"). The offset to the recorded compensation expense is an adjustment to "Additional paid-in capital" in Freddie Mac's consolidated balance sheets.

The fair value of stock-based options to purchase shares of Freddie Mac 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 expected life of the option, the market value of the underlying stock and its expected volatility, expected dividends on the stock, and the risk-free interest rate for the expected term of the option. The fair value of restricted stock and restricted stock unit awards is based on the grant-date fair value of Freddie Mac's common stock.

For stock-based compensation granted prior to 1995, Freddie Mac continues to apply the provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). Under APB 25, typically no compensation expense is recorded if the option exercise price is equal to the market price of the stock on the date of grant. Freddie Mac recognized compensation expense for restricted stock grants and dividend rights associated with stock options. No compensation expense was recognized for the ESPP since it is a qualifying plan under tax regulations.

Earnings Per Common Share

Basic earnings per common share is computed as net income available to common stockholders divided by the weighted average common shares outstanding for the period. Diluted earnings per common share is determined using the weighted average number of common shares during the period, adjusted for the dilutive effect of common stock equivalents. Dilutive common stock equivalents reflect the assumed issuance of additional common shares pursuant to certain of the company's stock-based compensation plans that could potentially reduce or "dilute" earnings per share, based on the treasury stock method as defined in SFAS No. 128, "Earnings per Share" ("SFAS 128").

Comprehensive Income

Comprehensive income, as defined in SFAS No. 130, "Reporting Comprehensive Income" ("SFAS 130"), 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 owners and distributions to owners. For Freddie Mac, comprehensive income is comprised of net income plus changes in the unrealized gains and losses on available-for-sale securities, the effective portion of derivatives accounted for as cash flow hedge relationships, and changes in the minimum pension liability.

Recently Adopted Accounting Standards and Accounting Changes

Consolidation of Variable Interest Entities — In January 2003, the FASB issued FIN 46. FIN 46 provides guidance for determining when a company must consolidate the assets, liabilities and activities of a variable interest entity. A variable interest entity is an entity (a) that has a total equity investment at risk that is not sufficient to finance its activities without additional subordinated financial support from other entities, or (b) where the group of equity holders does not have the ability to make significant decisions about the entity's

activities, or the obligation to absorb the entity's expected losses or the right to receive the entity's expected residual returns, or both. If an entity is a variable interest entity, the company must determine if its variable interest is significant and whether the company is the "primary beneficiary." Under FIN 46, a company is considered the "primary beneficiary" and must consolidate a variable interest entity when it absorbs a majority of expected losses or expected residual returns, or both. In addition, various disclosures are required about variable interest entities when an entity is not the primary beneficiary but holds a "significant variable interest" in a variable interest entity. In this case, significant variable interests are those in which Freddie Mac may be exposed to a significant portion of a variable interest entity's expected losses or expected residual returns, or both, which FIN 46 defines as a variability around the entity's expected returns or cash flows.

In December 2003, the FASB released FIN 46-R. The revision captured much of the guidance to date that had been provided by the FASB for implementation of FIN 46, clarified FIN 46 and revised certain effective dates for implementation. Freddie Mac adopted FIN 46-R for 2003. The implementation had no effect on the company's consolidated financial statements; however, the company has significant variable interests in certain variable interest entities that are not consolidated because the company is not the primary beneficiary. See "NOTE 3: VARIABLE INTEREST ENTITIES" for more information concerning variable interest entities.

Accounting For Financial Guarantees — Effective January 1, 2003, Freddie Mac adopted FIN 45 and FASB Staff Position 45-2, "Whether FASB Interpretation No. 45, 'Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,' Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value" ("FSP FIN 45-2"). FIN 45 requires that Freddie Mac recognizes the fair value of the company's obligation to guarantee the payment of principal and interest on PCs and other mortgage pass-through certificates that are issued by the company that are transferred to third parties. Such guidance also requires that the company recognizes the fair value of any consideration received in connection with the execution of such guarantees, which primarily includes the company's contractual right to receive guarantee fees. In consideration of FSP FIN 45-2, and effective January 1, 2003, Freddie Mac subsequently measures that portion of recognized guarantee obligations that relates to the company's non-contingent obligation to stand ready to perform using a systematic and rational method of amortization, while the company's contingent obligation to make payments under executed guarantees are accounted for pursuant to the requirements of SFAS 5. The implementation of FIN 45 and other such accounting changes in 2003 had a significant impact on our accounting for PC guarantees. Additionally, on January 1, 2003, Freddie Mac reclassified $110 million to Reserve for guarantee losses on Participation Certificates representing that portion of recognized guarantee obligations that was attributable to estimated incurred losses on outstanding PCs or Structured Securities on that date.

Accounting For Credit Enhancements — Effective January 1, 2003, Freddie Mac no longer subsequently measured recognized credit enhancements on a fair value basis. Such a change was made in conjunction with the change in the method by which recognized guarantee obligations are subsequently measured for consolidated financial statement purposes. This change necessitated a corresponding modification in the balance sheet classification of those credit enhancements that were previously recognized as a component of GAs and PC residuals since recognized GAs and PC residuals are subsequently measured on a fair value basis. In this regard, and effective January 1, 2003, $189 million related to credit enhancements was reclassified to Other assets ($128 million from the GA and $61 million from PC residuals) and, correspondingly, is amortized into earnings as a component of "Other expenses" at the greater of amounts calculated by amortizing recognized credit enhancements (a) in proportion to the rate of unpaid principal balance decline of covered mortgage loans or (b) on a straight-line basis over a credit enhancement contract term. The implementation of FIN 45 also resulted in a change in when credit enhancements were recognized for consolidated financial statement purposes. Based upon the view expressed in FIN 45 that guarantee transactions constitute exchange transactions, Freddie Mac now recognizes the fair value of credit enhancements as consideration received in connection with Guarantor and MultiLender Swap transactions (and other, similar transactions) as of the issuance date of those PCs that were issued on or after January 1, 2003. Prior to January 1, 2003, Freddie Mac did not recognize credit enhancements for consolidated balance sheet purposes until a PC or Structured Security to which such credit enhancements related was included in a transfer that qualified as a sale under SFAS 125/140.

Derivative Instruments and Hedging Activities — On January 1, 2001, Freddie Mac adopted SFAS 133, which required Freddie Mac to recognize all derivatives as either assets or liabilities on the consolidated balance sheets at fair value on a trade date basis. Freddie Mac's adoption of SFAS 133 on January 1, 2001, resulted in a cumulative $78 million after-tax increase to net income and a $2.6 billion after-tax reduction to AOCI, net of taxes. On July 1, 2003, Freddie Mac adopted SFAS No. 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS 149"). SFAS 149 amended and clarified the financial accounting and reporting for derivatives to incorporate decisions made by the FASB and the FASB's Derivative Implementation Group subsequent to the original issuance of SFAS 133 and in connection with other FASB projects. Under SFAS 149, purchase commitments for certain loans to be classified as held for investment must be accounted for as derivatives. The implementation of SFAS 149 did not have a material effect on the consolidated financial statements.

In September 2003, the Office of the Chief Accountant of the SEC published interpretive guidance on SFAS 133. To be consistent with the SEC guidance published at that time, Freddie Mac is reporting the income statement effects of derivatives not currently designated in hedge accounting relationships under SFAS 133 in a single line item on the company's consolidated statements of income, Derivative gains (losses), for all periods presented. Prior to 2003, the accrual for periodic cash settlements in accordance with the contractual terms of derivatives not in hedge accounting relationships was recorded in net interest income as a component of Income (expense) related to derivatives. Therefore, for periods prior to 2003, the impact of the accrual for these periodic derivative cash settlements has been reclassified from Income (expense) related to derivatives to Derivative gains (losses). The effect of this reclassification on the company's consolidated statements of income was to increase Net interest income by $639 million and $456 million for 2002 and 2001, respectively, and decrease Non-interest income by the same amounts. These reclassifications had no effect on net income.

Beneficial Interests: Interest Income Recognition and Impairment — Freddie Mac adopted EITF 99-20, on April 1, 2001. EITF 99-20 requires that the company recognize as interest income (throughout the life of a retained interest) the excess of all estimated cash flows attributable to retained interests over its principal amount using the effective yield method. The company updates its estimates of expected cash flows periodically and recognizes changes in calculated effective yield on a prospective basis. Prior to the company's implementation of EITF 99-20, the company recognized interest income for interest-only strips on the prospective effective interest method in accordance with EITF 89-4. Prior to the company's implementation of EITF 99-20, other-than-temporary impairment for such securities was defined under SFAS 115 or EITF 93-18, as applicable. Freddie Mac's adoption of EITF 99-20 on April 1, 2001, resulted in a cumulative $35 million after-tax decrease to net income.

Certain Financial Instruments with Characteristics of Both Liabilities and Equity — In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity" ("SFAS 150"). SFAS 150 changes the accounting for certain financial instruments that, under previous guidance, issuers could account for as equity. SFAS 150 requires that those instruments be classified as liabilities (or assets in some circumstances). SFAS 150 requires issuers to classify as liabilities the following three types of freestanding financial instruments: (a) mandatory redeemable financial instruments; (b) obligations to repurchase the issuer's equity shares by transferring assets; and (c) certain obligations to issue a variable number of shares. The adoption of SFAS 150 did not have an impact on the company's consolidated financial statements.

Accounting for the Impairment or Disposal of Long-Lived Assets — FASB Staff Position No. 144-1, "Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets"("FSP 144-1") became effective during 2003. FSP 144-1 prohibits the carrying over of loan loss allowances to the cost basis of foreclosed assets. Assets received in full satisfaction of a receivable are carried at fair value less cost to sell. In addition, FSP 144-1 limits gain recognition on foreclosed property to cumulative losses previously recognized in connection with the asset.

Disclosures about Pensions and Other Post-retirement Benefits — In December 2003, the FASB issued SFAS No. 132 (Revised 2003), "Employers' Disclosures about Pensions and Other Post-retirement Benefits" ("SFAS 132-R"), which retains the disclosure requirements contained in SFAS 132 and requires additional disclosure in financial statements about the assets, obligations, cash flows and net periodic benefit cost of defined benefit pension plans and other defined benefit post-retirement plans for periods ending after December 15, 2003, except for the disclosure of expected future benefit payments, which must be disclosed for fiscal years ending after June 15, 2004. Certain disclosures required by this statement are effective for interim periods beginning after December 15, 2003. Accordingly, the new annual disclosures are included in "NOTE 15: EMPLOYEE BENEFITS."

Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock — Freddie Mac accounts for the EPS effects of preferred stock redemptions in accordance with EITF Topic No. D-42, "The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock" ("EITF D-42"). EITF D-42 states that when there is a redemption or induced conversion of preferred stock, the excess of the fair value of the consideration transferred to preferred stockholders over the carrying amount of the preferred stock must be subtracted from net income to determine net income available to common stockholders in the calculation of earnings per share. The SEC Observer, a representative from the SEC's Chief Accountant's Office, issued clarifying guidance to companies in July 2003 that affected Freddie Mac's EPS calculation. This clarification of EITF D-42 was required to be reflected retroactively in consolidated financial statements for reporting periods ending after September 15, 2003 by restating the consolidated financial statements of prior periods. The SEC Observer commented that, for the purposes of calculating the excess of the fair value of the consideration transferred to the holders of the preferred stock over the carrying amount of the preferred stock, the carrying amount of the preferred stock should be reduced by the issuance costs of the preferred stock regardless of where in the stockholders' equity section those costs were initially classified upon issuance. Freddie Mac did not redeem preferred stock in 2001 or 2003. For 2002 Freddie Mac's earnings per share calculation was restated to include issuance costs in determining the carrying amount of the preferred stock that was redeemed in 2002, in response to this clarification. For the year ended December 31, 2002, the restatement increased by $5 million the amount representing issuance costs on redeemed preferred stock and therefore reduced "Net income available to common stockholders" by $5 million. This caused a reduction in both basic and diluted earnings per share for the same year by $0.01 per share.

Recently Issued Accounting Standards

Certain Loans or Debt Securities Acquired in a Transfer — In December 2003, the Accounting Standards Executive Committee of the AICPA issued Statement of Position No. 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer" ("SOP 03-3"). SOP 03-3 addresses the accounting for differences between the contractual cash flows and the cash flows expected to be collected from purchased loans or debt securities if those differences are attributable, in part, to credit quality. The scope of SOP 03-3 is limited to purchased loans or debt securities with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable. SOP 03-3 requires purchased loans and debt securities to be recorded initially at fair value based on the present value of the cash flows expected to be collected with no carryover of any valuation allowance previously recognized by the seller. Interest income should be recognized based on the effective yield from the cash flows expected to be collected. To the extent that the purchased loans or securities experience subsequent deterioration in credit quality, a valuation allowance or impairment charge would be recognized for any additional cash flows that are not expected to be received. However, if more cash flows subsequently are expected to be received than originally estimated, the effective yield would be adjusted on a prospective basis. SOP 03-3 will be effective for certain loans and debt securities acquired after December 31, 2004. The company is evaluating the future impact of SOP 03-3 on its financial position and results of operations.

Other than Temporary Impairment — In November 2003, the FASB's Emerging Issues Task Force ("EITF") reached a consensus requiring certain disclosures for impaired securities as described in EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments."

The new disclosures apply to debt and equity investments as defined under SFAS 115, and are effective for fiscal years ending after December 15, 2003. The guidance requires disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The EITF also reached consensus in March 2004 concerning the applicability of the disclosure requirements to a wider variety of investments. (See "NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO"). Also, in March 2004, the EITF reached measurement consensus, which is effective beginning in the third quarter of 2004. The FASB is now deliberating the issuance of two FASB Staff Positions ("FSPs") that may defer the effective date of and modify the measurement guidance contained in EITF 03-1. The measurement consensus provides guidance regarding when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. It also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment. The company is evaluating the future impact of the measurement consensus in EITF 03-1 and, while the company is not yet able to estimate the impact, it could be material to our financial position and results of operations.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 — The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was signed into law on December 8, 2003. As permitted under FASB Staff Positions ("FSPs") 106-1 and 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003," Freddie Mac elected to defer accounting for certain of the effects of the Act pending issuance of final guidance and transition rules. Freddie Mac is currently reviewing the Act and the potential impact on its post-retirement medical plan with the assistance of its actuary. Accordingly, the accumulated post-retirement benefit obligation and net periodic benefit costs related to this plan do not reflect the effects of the Act. FSP 106-2 requires a determination as to whether the effect of the Medicare legislation will be significant to Freddie Mac. FSP 106-2 provides for alternative methods of adoption depending upon whether Freddie Mac's Plan is considered "actuarially equivalent" to Medicare and whether the effects of the Act are significant to Freddie Mac. Freddie Mac is working with its actuary to assess the significance of the Act's effects, and adoption implications.

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

Types of Securitization Transactions Executed By Freddie Mac

Freddie Mac issues two types of mortgage-related securities: Mortgage Participation Certificates (or "PCs") and Structured Securities. PCs represent undivided interests in pools of mortgage loans that are secured by either single-family or multifamily loans. Similarly, Structured Securities represent undivided interests in PCs or other mortgage-related securities that are issued by either Ginnie Mae or non-agency issuers. Freddie Mac guarantees the payment of principal and interest on all issued PCs and Structured Securities.

Freddie Mac issues PCs in several different contexts:

- Single-family mortgage loans that are purchased by Freddie Mac through its Cash Window are either retained by Freddie Mac in its Retained portfolio or are sold through auction in the form of issued PCs. Certain of those single-family mortgage loans that are retained by Freddie Mac in its Retained portfolio are securitized and, therefore, are held as investments in the form of PCs. Those mortgage loans that are purchased through the Cash Window that are not retained by Freddie Mac are pooled together with other single-family mortgage loans that are received in connection with PC swap-based transactions that it executes with various lenders (and which are commonly referred to as "MultiLender Swaps"). Issued PCs in this case that are not delivered to third party lenders in connection with MultiLender Swap transactions are then sold by Freddie Mac for cash consideration through an auction.

- Freddie Mac also commonly issues PCs to third parties through PC-swap-based transactions where either single-family or multifamily mortgage loans are delivered to Freddie Mac in exchange for PCs backed by such pools of mortgage loans. In this regard, and unlike MultiLender Swap transactions, the pools of mortgage loans formed in this case relate exclusively to mortgage loans that are delivered to Freddie Mac by a single lender.

Freddie Mac also sells PCs that are held in portfolio in resecuritized form as Structured Securities. More specifically, Freddie Mac issues single and multiple class-based Structured Securities that are backed by PCs and other mortgage-related securities held in portfolio and subsequently transfers such Structured Securities to third parties in exchange for cash consideration. Freddie Mac also commonly issues Structured Securities in exchange for PCs and other mortgage-related securities that are delivered to it by third party dealers who, in turn, sell such Structured Securities to retail and institutional investors.

Retained Interests Created Through The Securitization Process

Freddie Mac's retained interests in securitized and resecuritized mortgage-related assets include the following:

- PCs retained by Freddie Mac that are backed by conforming single-family mortgage loans and multifamily mortgage loans for which Freddie Mac paid cash consideration.

- Structured Securities retained by Freddie Mac in connection with the resecuritization of PCs and Ginnie Mae Certificates.

- Freddie Mac's contractual right to receive a negotiated fraction of the interest-related cash flows of securitized mortgage loans which relates to compensation due Freddie Mac in connection with its guarantee and administration of payments of principal and interest on issued PCs. This retained, undivided interest is referred to as a GA.

- PC residuals, which relate to certain PCs and Structured Securities held by Freddie Mac and represent the fair value of the expected future cash flows of guarantee and bond administration cash flows that are contractually distinct from that of such corresponding PCs or Structured Securities.

Unpaid Principal Balances of Issued PCs and Structured Securities

Table 2.1 below presents the unpaid principal balances of PCs issued and Structured Securities as of December 31, 2003 and December 31, 2002.

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

	December 31,	
	2003	2002
	(dollars in millions)	
PCs and Structured Securities		
Held by third parties(3)	$ 752,164	$ 729,809
Held by Freddie Mac in the:		
Retained portfolio(4)	393,135	341,287
Cash and investments portfolio(3)(5)	16,769	19,528
Total issued PCs and Structured Securities(6)(7)	$1,162,068	$1,090,624

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

(2) Due to the nature of security program remittance cycles of issued PCs and Structured Securities, the unpaid principal balances of the underlying mortgage loans do not equal the unpaid principal balances of issued PCs and Structured Securities. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Due to Participation Certificate Investors" for more information.

(3) Subsequent to the release of Freddie Mac's Information Statement dated February 27, 2004, the company revised the balance of PCs and Structured Securities in the Cash and investments portfolio due to a calculation error. The effect of this change was a $584 million decrease in PCs and Structured Securities in the Cash and investments portfolio at December 31, 2002 and a corresponding increase in PCs and Structured Securities – Held by third parties. The consolidated financial statements were not affected by this revision.

(4) With respect to mortgage loans purchased through Freddie Mac's Cash Window that were internally securitized as PCs and held as available-for-sale investments by the Retained portfolio, the company recognized losses of $178 million and $22 million for the years ended December 31, 2003 and 2002, respectively, that correspond to permanent lower of cost or market value adjustments that were recognized in connection with such mortgage loans. Such lower of cost or market value adjustments were treated as basis adjustments to such issued PCs and, as such, are amortized into interest income over the holding period of such securities.

(5) Represents PCs and Structured Securities held by Freddie Mac in connection with PC market-making and support activities, which are reflected in Investments on the consolidated balance sheets.

(6) As further discussed in "NOTE 4: FINANCIAL GUARANTEES," these amounts include:
- $4,729 million and $8,561 million of Structured Securities backed by Ginnie Mae Certificates at December 31, 2003 and 2002, respectively.
- $5,044 million and $4,643 million at December 31, 2003 and 2002, respectively, that pertain to our guarantee of the payment of principal and interest on (a) tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties and (b) multifamily mortgage loans that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds.
- $2,278 million and $–0– at December 31, 2003 and 2002, respectively, of single-family mortgage loans held by third parties for which we provided a credit guarantee.

(7) PCs and Structured Securities exclude $637,491 million and $752,671 million at December 31, 2003 and 2002, respectively, of Structured Securities where Freddie Mac has resecuritized PCs and other previously issued Structured Securities. These excluded Structured Securities do not increase Freddie Mac's credit related exposure and consist of single-class Structured Securities backed by PCs, Real Estate Mortgage Investment Conduits, or REMICs and principal-only strips. The notional balance of interest-only strips of $91,192 million and $113,654 million at December 31, 2003 and 2002, respectively, is excluded because this table is based on unpaid principal balances. Also excluded are modifiable and combinable REMIC tranches and interest and principal classes, which collectively total $988,600 million and $1,301,666 million at December 31, 2003 and 2002, respectively, where the holder has the option to exchange the security tranches for other pre-defined security tranches.

At December 31, 2003 and 2002, approximately 78 percent and 49 percent, respectively, of issued PCs and Structured Securities (excluding securities issued by Freddie Mac and backed by Ginnie Mae Certificates or non-agency mortgage-related securities and other securities guaranteed by Freddie Mac) had corresponding GAs, GOs or PC residuals recognized on Freddie Mac's consolidated balance sheets. In comparison, as of December 31, 2003 and 2002, 81 percent and 54 percent, respectively, of PCs and Structured Securities held by third parties had a related guarantee asset and guarantee obligation established. At December 31, 2003, 30 percent of these PCs and Structured Securities had corresponding GAs, GOs or PC residuals recognized on Freddie Mac's consolidated balance sheets due to the adoption of FIN 45 accounting on January 1, 2003.

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

Freddie Mac recognized pre-tax gains of approximately $711 million, $874 million and $311 million for the years ended December 31, 2003, 2002 and 2001, respectively, on transfers of PCs and Structured Securities that were accounted for as sales under SFAS 125/140. (Subsequent to the issuance of our 2002 Information Statement dated February 27, 2004, Freddie Mac revised the amounts reported as gain on sale for the years ended December 31, 2002 and 2001, respectively, to conform such previously reported amounts with

methods used in 2003 to quantify gains on sales. Such methods are described below). In connection with the derivation of such gains (losses), the following can be observed:

- Such amounts are exclusive of gains (losses) on transfers of PCs and Structured Securities for which all underlying mortgage-related assets were identified as having been previously sold for GAAP purposes;
- With respect to the sale of PCs and Structured Securities (a) that were classified as trading for investment accounting purposes and (b) for which no GAs and GOs were previously recognized, such gains (losses) were calculated based upon the settlement date (of the sale) differences between recognized GAs and GOs; and
- With respect to the sale of PCs and Structured Securities (a) that were classified as trading for investment accounting purposes and (b) for which a corresponding PC residual balance was recognized and classified as trading, no related gain (loss) was included in such amounts given that, through the point of sale, all related gains (losses) on such securities would have already been recognized in earnings.

Key Valuation Assumptions Associated with Recognized GAs, GOs, Credit Enhancements and PC Residuals that Correspond to PCs or Structured Securities Backed by Single-Family Mortgages

Freddie Mac recognizes GAs and GOs for PCs backed by residential mortgage loans and multifamily mortgage loans in conjunction with transfers accounted for as sales under 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. At December 31, 2003, GAs totaled $3,686 million on Freddie Mac's consolidated balance sheet and of that amount, approximately $24 million (or less than 1 percent), relates to guarantees of multifamily mortgage loans. Consequently, the following discussion of key valuation assumptions and corresponding sensitivity analysis of recognized GAs, GOs, credit enhancements and PC residuals focuses solely on PCs and Structured Securities backed by single-family mortgage loans.

Recognized GAs

Fair values of recognized GAs were calculated using an expected cash flow approach. Specifically, Monte Carlo simulations were used to project monthly prepayment and default rates across 300 housing price and interest rate scenarios. For the years ended December 31, 2002 and 2001, Monte Carlo simulations were also used to project monthly loss severity rates given that recognized GAs considered the fair value of pool insurance, recourse and indemnifications. As discussed above in NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Freddie Mac discontinued the inclusion of the referenced types of credit enhancements as component parts of recognized GAs effective January 1, 2003. Therefore, effective January 1, 2003, monthly loss severity rates were no longer included as part of Monte Carlo simulations that were executed in connection with the projection of future cash flows associated with GAs. In all cases, such projections were used to forecast GA-related future cash flows associated with approximately 300,000, 200,000 and 200,000 groups of mortgage loans for 2003, 2002 and 2001, respectively, that are distinguished based upon differing combinations of various loan attributes (these groups of loans are referred to as "Loan Groups"). Freddie Mac then discounted the forecasted cash flows using factors that were derived from modeled forward interest rates (for each scenario path) and to which Freddie Mac applied an option-adjusted spread that was implied from comparable agency interest-only securities.

For periods prior to March 31, 2001, Freddie Mac applied an option-adjusted spread of 150 basis points in deriving appropriate discount rates, an adjustment management concluded was an appropriate premium based on available interest-only security price information from the referenced periods (to which the option-adjusted spread was applied). For periods subsequent to March 31, 2001, as additional option-adjusted spread data became available, Freddie Mac improved this estimate by beginning to apply a trailing average option-adjusted spread of up to eight quarters that was derived from spot interest-only security prices (the trailing average option-adjusted spreads ranged from 250 to 770 basis points between March 31, 2002 and December 31, 2003).

Based upon the foregoing, Freddie Mac recognized the average of the present value of the GA-related cash flow generated for each Loan Group for each of the referenced scenarios as GAs. Effective January 1, 2003, Freddie Mac modified the composition of GA-related cash flows used to derive fair value as a result of changes to the accounting policies (changes of which are further described in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES"):

- Through December 31, 2002, the derived fair values of recognized GAs include the estimated benefit of pool insurance and third party-provided recourse less the associated estimated premium payments (where applicable) Freddie Mac would be required to make under the terms of these credit enhancements. In 2003, Freddie Mac excluded the estimated benefits (net of related estimated payment obligations) of such credit enhancements as a component of its recognized GAs.
- Through December 31, 2002, and with respect to PCs issued to third parties in swap-based transactions that were not accounted for as sales under SFAS 125/140, GA-related cash flows that were used for valuation purposes included only that portion of contractual guarantee fees that corresponded to Buy Ups paid by Freddie Mac. However, with respect to those PCs that were issued through such programs on or after January 1, 2003, GA-related cash flows that were used for valuation purposes included all contractual guarantee fees.

Recognized GOs

GOs are recognized at fair value at the inception of an executed guarantee and the fair value of a GO constitutes a component part of the valuation of a PC residual (where recognized PC residual is effectively equivalent to the net fair value of the underlying GA and GO). In this regard, and like the cash flows associated with recognized GAs, GO-related future cash flows associated with each referenced Loan Group were estimated using Monte Carlo simulation. The components of estimated future cash flows associated with GOs include: (a) estimates of expected future credit losses using statistically based models that evaluate a variety of factors (such as default experience and loss severity trends) as well as an estimated risk premium for the uncertainty in expected credit losses that would be required to be paid to a third party with a credit standing, capital structure and regulatory oversight similar to those of Freddie Mac; (b) estimates of those costs to administer the collection and distribution of payments on the mortgage loans underlying a PC; and (c) expected net cash flows due to security program cycles. When deriving the present value of GO-related cash flows for each scenario for each Loan Group, Freddie Mac used a convention that is similar to the methodology described above to discount GA-related future cash flows, except that a risk-free rate was used to discount such cash flows. Additionally, projected credit related costs that were factored into the GO related cash flows were benchmarked to the non-conforming loan securitization market.

Like recognized GAs, Freddie Mac recognized as GOs the average of the present value of the GO-related cash flows generated for each Loan Group for each of the scenarios.

Recognized PC residuals

PC residuals relate to certain PCs and Structured Securities held by Freddie Mac in its Retained portfolio and Cash and investments portfolio and represent the fair value of the future cash flows of guarantee contracts that specifically correspond to such PCs. Since the future cash flows associated with such guarantee contracts are represented by those that define a PC's corresponding GA and GO, the fair value of a recognized PC residual is effectively equivalent to the fair value of a GA less that of a corresponding GO. Accordingly, the fair value of recognized PC residuals is determined in a manner that is reflective of the methodologies described above for recognized GAs and GOs.

Recognized Credit Enhancements

Many of the credit enhancements that Freddie Mac employs in connection with securitized mortgage loans are recognized at fair value at the inception of each contract. In this regard, credit enhancements-related future cash flows associated with each referenced Loan Group were estimated using a Monte Carlo simulation. More specifically, and based upon the terms of a credit-enhancement contract, that portion of the

total estimated expected and unexpected credit loss components of GO-related future cash flows that were estimated for each Loan Group that would be reimbursed to Freddie Mac by a third party (e.g., a mortgage insurer) are identified as the estimated future cash inflows due Freddie Mac on each of such contracts. Projected cash inflows in this case were then discounted using a risk free rate.

Freddie Mac recognized as an Other asset the average of the present value of the credit-enhancement-related cash flows generated for each Loan Group for each of the scenarios related to pool insurance, recourse and indemnifications, while the average of the present value of the credit enhancements-related cash flows generated for each Loan Group for each of the scenarios related to primary mortgage insurance is recognized at inception at fair value as a reduction of recognized GOs.

Credit enhancements that were recognized as Other assets had a carrying value of approximately $195 million at December 31, 2003.

Other Retained Interests

Other Retained Interests (as defined in footnote 3 to Table 2.3 below) are valued based upon observed market or matrix-based prices (for the latter, prices for comparable securities, as adjusted for product-specific attributes, are used as a basis to value such interests). Because these interests are not model-valued, corresponding valuation assumptions are not provided in Table 2.2 below.

Table 2.2 summarizes the key assumptions Freddie Mac used in fair value measurements of recognized GAs, GOs and PC residuals.

Table 2.2 — Key Assumptions Utilized in Fair Value Measurements[1]

	2003		2002		2001	
	GA, GO and PC residual		GA, GO and PC residual		GA, GO and PC residual	
Assumptions	Range[6]	Mean[7]	Range[6]	Mean[7]	Range[6]	Mean[7]
Internal rates of return[2]						
GA	4.5%-15.1%	9.4%	5.9% - 15.7%	9.4%	5.3%-17.5%	9.6%
GO	1.9%-9.5%	5.6%	3.8% - 8.2%	6.0%	4.8%-8.1%	6.6%
PC residual	4.0%-12.2%	7.6%	5.1% - 11.8%	7.4%	5.1%-12.5%	7.9%
Prepayment rates[3]	7.5%-62.9%	22.6%	8.8% - 54.6%	22.5%	9.7%-53.7%	21.3%
Default rates[4]	0.1%-8.5%	1.2%	0.1% - 8.1%	1.2%	0.0%-8.1%	1.2%
Loss severity rates[5]	4.0%-46.0%	24.6%	3.6% - 48.4%	22.9%	3.7%-48.4%	22.6%

(1) The assumptions included in this table relate to those used to measure the fair value of GAs, GOs and PC residuals at the time of securitization, which occurred throughout each of the years presented. Additionally, the range of assumptions used to facilitate the valuation of recognized credit enhancements was consistent with those provided above for recognized GOs.
(2) The internal rates of return ("IRR") reported above represent a duration weighted average of the discount rates used to value recognized GAs and GOs. Such rates were derived by determining a single rate that equated (a) the simple average of future cash flows (for all 300 scenario paths described above) of the GA and GO for each Loan Group with that of (b) the calculated fair value of the GA and GO for each loan group. With respect to PC residuals, IRRs reported above represent the weighted average of the derived IRR values for corresponding GAs and GOs (where weightings are based upon the fair values of corresponding GAs and GOs).
(3) Scenario average Prepayment rates are simulated on a monthly frequency, although rates reported above represent an unpaid principal balance weighted average of annualized values of such Prepayment rates. With respect to GAs related to PCs backed by multifamily mortgage loans.
(4) Default rates are simulated on a monthly frequency, although Default rates reported above represent simple averages of cumulative default rates determined for each of the 300 scenarios for each Loan Group.
(5) Loss severity rates reported above represent the ratio of (a) the simple average of cumulative credit losses generated for each scenario to (b) defaulted unpaid principal balance for each Loan Group.
(6) The lowest value in each presented range represents the smallest first percentile IRRs, prepayment rates, default rates, and loss severity rates throughout 2003 and 2002. Likewise, the highest value in each range represents the highest of the 99th percentile IRRs, prepayment rates, default rates, and loss severity rates throughout 2003 and 2002.
(7) Reported values represent the weighted average value of all IRRs, prepayment rates, default rates, and loss severity rates throughout the 2003, 2002 and 2001 periods.

Weighted average lives of GAs and PC residuals during 2003, 2002 and 2001 ranged between 1.0 – 8.6 years, 1.5 – 7.8 years and 1.5 – 8.1 years, respectively, while the average, derived weighted average lives of GAs and PC residuals for the same periods was 4.8, 5.0 and 4.9 years, respectively. Such derived weighted average lives are reflective of prepayment speed assumptions cited in Table 2.2 above.

A sensitivity analysis is provided in Table 2.3 below that illustrates estimated changes in the fair value as of December 31, 2003 of recognized GAs, PC residuals and other retained interests (which are further described below) based upon:

- 100 basis point and 200 basis point increases and decreases in discount rate assumptions.
- 10% and 20% increases and decreases in prepayment rate assumptions.
- 10% and 20% increases in default rate assumptions.
- 10% and 20% increases in loss severity rate assumptions.

GOs are not included in the sensitivity analysis in Table 2.3 since such items are not subsequently measured on a fair value basis in the consolidated balance sheets.

Table 2.3 — Sensitivity Analysis

	As of December 31, 2003		
	PC residual[1]	GA[2]	Other Retained Interests[3]
	(dollars in millions)		
Fair value	$ 666	$3,686	$1,537[4]
Weighted average IRR assumptions:	6.5%	7.5%	8.8%
Impact on fair value of 100 bps upward change	$ (18)	$ (134)	$ (47)
Impact on fair value of 200 bps upward change	$ (35)	$ (259)	$ (96)
Impact on fair value of 100 bps downward change	$ 17	$ 132	$ 63
Impact on fair value of 200 bps downward change	$ 32	$ 256	$ 125
Weighted average prepayment rate assumptions:	17.6%	19.1%	12.9%
Impact on fair value of 10% upward change	$ (10)	$ (165)	$ (25)
Impact on fair value of 20% upward change	$ (21)	$ (314)	$ (53)
Impact on fair value of 10% downward change	$ 9	$ 183	$ 40
Impact on fair value of 20% downward change	$ 18	$ 389	$ 80
Weighted average default rate assumptions:	1.1%	1.2%	N/A[5]
Impact on fair value of 10% upward change	$ (75)	$ (3)	N/A[5]
Impact on fair value of 20% upward change	$ (149)	$ (6)	N/A[5]
Weighted average loss severity rate assumptions:	27.0%	N/A[6]	N/A[5]
Impact on fair value of 10% upward change	$ (99)	N/A[6]	N/A[5]
Impact on fair value of 20% upward change	$ (200)	N/A[6]	N/A[5]

(1) At December 31, 2003 and 2002, approximately $47 million and $55 million, respectively, of recognized PC residuals were classified as available for sale and which, as a function of the unpaid principal balances of related PCs or Structured Securities, represented approximately 19 percent of recognized PC residuals. Therefore, approximately 81 percent of the future change in fair value of recognized PC residuals would be recognized in earnings, while the balance of such future changes in fair value would be reflected in AOCI, net of taxes."

(2) At December 31, 2003, GAs totaled $3,686 million on Freddie Mac's consolidated balance sheet and of that amount, approximately $24 million (or less than 1 percent), relates to PCs backed by multifamily mortgage loans. The sensitivity analysis presented in Table 2.3 relates solely to GAs associated with PCs backed by single-family mortgage loans.

(3) Includes interest-only securities that were issued by Freddie Mac as part of a resecuritization transaction for which sale accounting treatment was applied, Freddie Mac securities that were (a) purchased at a premium (to par) of 10 percent or greater and (b) associated with either a securitization or resecuritization transaction for which sale accounting treatment was applied. Also included are Freddie Mac securities held by the company for which securitized / resecuritized mortgage-related assets were (a) not of high credit quality and (b) associated with either a securitization or resecuritization transaction for which sale accounting treatment was applied.

(4) Includes accrued interest.

(5) Sensitivities of reported fair value to changes in default and loss severity rates associated with Other retained interests for which a recognized PC residual exists are captured in the corresponding column entitled PC residual. Otherwise, with respect to Other Retained Interests for which a PC residual was not recognized, such securities are valued for consolidated financial statement purposes at the observed market price for such securities, prices of which reflect inherent credit protection provided by Freddie Mac. In this case, changes in the reported fair value of such securities would not be affected by variations in default and loss severity assumptions and, as a result, a corresponding sensitivity analysis was not prepared.

(6) Severity of loss has no impact on the underlying cash flows of the guarantee asset or the resultant fair values.

The sensitivity analysis in the preceding table is hypothetical. Each of the calculated effects summarized above was determined by adjusting only one assumption at a time, as opposed to having determined a hypothetical effect on fair value based upon assumed, correlating changes in more than one assumption (where, in reality, a change in one assumption would generally result in changes to one or more of the other specified assumptions). Additionally, corresponding hedge transactions that were executed by Freddie Mac were not considered in determining the hypothetical effects summarized above. Results provided above should not be extrapolated to either (a) other sensitivity analyses in which changes in other assumptions are made or (b) to other securities held by Freddie Mac.

Periodic Cash Flows on Transfers of Securitized Interests and Corresponding Retained Interests

Table 2.4 below summarizes:

- Cash flows received by Freddie Mac in connection with transfers of all PCs and Structured Securities to third parties that were accounted for as sales where retained interests related to guarantee activities are initially recognized or resulted from a resecuritization transaction;
- Contractual guarantee-related cash flows received by Freddie Mac in connection with recognized GAs (as further discussed below);
- Contractual guarantee-related cash flows received by Freddie Mac in connection with recognized PC residuals (as further discussed below);
- Receipts of payments of principal and interest on Other Retained Interests; and
- Amounts paid by Freddie Mac in connection with the process to repurchase delinquent mortgage loans that back PCs and Structured Securities.

Table 2.4 — Details of Cash Flows

	Year Ended December 31,		
	2003	2002(1)	2001(1)
	(dollars in millions)		
Cash flows from:			
Transfers of Freddie Mac securities that were accounted for as sales	$347,874	$241,214	$158,166
Cash flows received on retained interests:			
GAs(2)	888	771	751
PC residuals(2)	439	325	263
Other Retained Interests	810	654	366
Purchases of delinquent or foreclosed loans(3)	(6,295)	(5,126)	(3,745)

(1) Certain cash flow amounts previously reported for the years ended December 31, 2002 and 2001 have been revised to reflect current year quantification methods.
(2) Amounts specifically correspond to guarantee fee-related cash flows of recognized GAs and PC residuals, and do not reflect cash flows received in connection with certain credit enhancements whose fair value in 2002 and 2001 was also reported as GAs or PC residuals or certain GO-related cash flows whose value was reported as a component of recognized PC residuals. Total cash flows received on recognized GAs during 2003, 2002 and 2001 were $888 million, $820 million and $803 million, respectively. Total net cash flows received on recognized PC residuals during 2003, 2002 and 2001 were $130 million, $169 million and $191 million, respectively. Total GA cash flows and total (net) cash flows or PC residuals in 2003 are exclusive of proceeds received in connection with credit enhancements.
(3) Represents delinquent mortgage loans purchased out of securitized pools that back issued PCs or Structured Securities.

Attribution of GA- and PC Residual-Related Cash Flows

As previously discussed, GAs and PC residuals are financial assets accounted for on a fair value basis. Similar to other financial assets, cash flows received in connection with GAs and PC residuals represent both a return *on* such assets (*i.e.*, imputed interest) as well as a return *of* such assets (*i.e.*, return of principal). Freddie Mac receives cash flows on these assets related to contractual guarantee fees. Additionally, Freddie Mac receives or pays other cash flows associated with PC residuals that relate to the PC guarantee contract, such as credit-related expenses and administrative expenses.

Rather than recording a portion of the cash flows associated with GAs and PC residuals as a reduction of their respective recorded amounts, similar to a return of principal, the related income and expense amounts are recorded directly to the consolidated statements of income based on the nature of such cash flows. For example, guarantee-related cash inflows are recorded as Management and guarantee income. As these cash flows are received, the remaining cash flows (and the related GA and PC residual fair values) also decrease. These decreases related to the GA and PC residuals are reflected in the Gains (losses) on Guarantee asset for Participation Certificates, at fair value and Gains (losses) on investment activity, respectively.

Recognized GAs — Guarantee Fee-Related Cash Flows

Freddie Mac recorded $888 million, $771 million and $751 million of income associated with guarantee-related cash flows received during 2003, 2002 and 2001, respectively. These amounts were recorded to Management and guarantee income. Of such amounts, approximately $244 million, $242 million and $252 million, respectively, related to imputed interest. The remaining portion related to return of principal, which totaled $644 million, $529 million and $499 million for 2003, 2002 and 2001, respectively.

Recognized GAs — All Cash Flows

As noted above, Freddie Mac discontinued the inclusion of credit enhancements as a component part of recognized GAs effective January 1, 2003. As a result, imputed interest amounts reported above for 2003 do not consider cash flows received that relate to credit enhancements that were previously recorded as a component of recognized GAs. With respect to amounts reported in 2002 and 2001, Freddie Mac recorded total income of $820 million and $803 million, respectively, associated with recognized GAs. Approximately $259 million and $273 million of such amounts constitute imputed interest for 2002 and 2001, respectively, while the remaining portions, which totaled $561 million and $530 million, related to return of principal for 2002 and 2001, respectively.

Recognized PC residuals

Freddie Mac recorded $439 million, $325 million and $263 million of income associated with guarantee-related cash flows received (in connection with the GA component of recognized PC residuals) during 2003, 2002 and 2001, respectively. These amounts were recorded to interest income. Of these amounts, approximately $109 million, $96 million and $93 million during 2003, 2002 and 2001, respectively, related to imputed interest. The remaining portion related to return of principal, which totaled $330 million, $229 million and $170 million during 2003, 2002 and 2001, respectively.

Considering all cash flows related to recognized PC residuals (*i.e.*, related to both the GA and GO components of recognized PC residuals), the amount of imputed interest on PC residuals was approximately $66 million, $73 million and $76 million during 2003, 2002 and 2001, respectively. Consistent with the description above, however, cash flows used to derive the referenced, imputed interest for 2003 were exclusive of proceeds received in connection with credit enhancements.

NOTE 3: VARIABLE INTEREST ENTITIES

The company is a party to numerous entities that may be considered to be variable interest entities under FIN 46-R. These variable interest entities include low-income multifamily housing tax credit partnerships, certain Structured Securities trusts, and certain asset-backed investment entities. In addition, Freddie Mac buys the highly-rated senior securities in certain mortgage securitization trusts that are variable interest entities. 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. Freddie Mac's investments in these securities do not represent a significant variable interest in the securitization trusts. Further, Freddie Mac invests in securitization entities that are qualifying special purpose entities ("QSPEs") as described in SFAS 125/140. Interests in QSPEs are exempt from FIN 46-R unless a company has the unilateral ability to liquidate or change the QSPE.

The company implemented FIN 46-R in 2003 and adopted FIN 46-R for 2003 year-end reporting. The implementation had no effect on Freddie Mac's consolidated financial statements. However, the company had significant variable interests in certain variable interest entities (that are not consolidated because the company is not the primary beneficiary) as described below. Significant variable interests are those in which Freddie Mac may be exposed to a significant portion of a variable interest entity's expected losses or expected residual returns, which FIN 46-R defines as variability around the variable interest entity's expected returns or cash flows. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Consolidation of Variable Interest Entities" for information concerning FIN 46.

Low Income Housing Tax Credit Partnerships

Freddie Mac invests as a limited partner in low-income housing tax credit partnerships formed for the purpose of providing funding for affordable multifamily rental properties. These low-income housing tax credit partnerships invest directly in limited partnerships that develop or rehabilitate multifamily rental properties. Completed properties are rented to qualified low-income tenants, allowing the properties to be eligible for federal tax credits. A general partner operates the partnership, identifying investments and obtaining debt financing as needed to finance partnership activities. Although these partnerships generate operating losses, Freddie Mac realizes a return on its investment through reductions in income tax expense that result from tax credits and the deductibility of the operating losses. The partnership agreements are typically structured to meet a required 15-year period of occupancy by qualified low-income tenants. These investments were made between 1989 and 2003. At December 31, 2003, Freddie Mac did not guarantee any obligations of these partnerships and Freddie Mac's exposure is limited to the amount of its investments.

As of December 31, 2003, the company had unconsolidated investments in 130 housing tax credit partnerships in which it is reasonably possible that Freddie Mac has a significant variable interest. The size of these partnerships at December 31, 2003, as measured in total assets, was approximately $5.9 billion. These partnerships are accounted for using the equity method, as described in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES."

As a limited partner, Freddie Mac's maximum exposure to loss equals the book value of its equity investment. As of December 31, 2003, Freddie Mac's maximum exposure to loss on unconsolidated housing tax credit partnerships, in which it is reasonably possible that Freddie Mac has a significant variable interest, was approximately $2.2 billion. Low-income housing tax credit partnerships created on or after February 1, 2003 were evaluated under FIN 46-R and there was no impact to the consolidated financial statements. Under the transition provisions of FIN 46-R, those partnerships created prior to February 1, 2003 will be evaluated in 2004 and any impact to the consolidated financial statements is not expected to be material.

Asset-backed Investment Trusts

Freddie Mac invests 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. The trusts act as vehicles to allow originators to securitize assets. 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.

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. Freddie Mac invests in these securities to manage its cash flows, create a diverse source of liquidity and achieve profitable investment returns. These investments were made between 2000 and 2003.

At December 31, 2003, the company had investments in 15 trusts related to asset-backed securities in which Freddie Mac has a significant variable interest. The size of these non-mortgage asset-backed trusts at December 31, 2003, as measured by total assets, was approximately $7.9 billion.

As an investor, Freddie Mac's maximum exposure to loss consists of the book value of its investment. As of December 31, 2003, Freddie Mac's maximum exposure to loss on non-mortgage asset-backed trusts in which Freddie Mac has a significant variable interest was approximately $1.8 billion. These investments are typically senior interests rated AA – AAA.

Structured Securities — T-Series Trusts

In T-Series transactions (or alternative collateral deals), a seller or sellers of mortgage loans transfers mortgage loans to a trust specifically for the purpose of issuing securities collateralized by the mortgage loans. The trust issues various senior and subordinated interests. Freddie Mac guarantees and purchases certain senior interests issued by the trust. The subordinated interests of the trust are generally either held by the seller or other party or sold in the capital markets. Simultaneous with the guarantee and purchase of certain senior interests issued by the trust, Freddie Mac issues Structured Securities, which Freddie Mac guarantees. These Structured Securities represent an interest in the senior interests issued by the trust.

At December 31, 2003, the company had investments or guarantees related to two T-Series trusts, in which Freddie Mac has a significant variable interest. Freddie Mac's involvement in the trusts began in 1996 and 2002, respectively. The size of these trusts at December 31, 2003, as measured in total assets, was approximately $367 million.

As of December 31, 2003, Freddie Mac's maximum exposure to loss on T-Series transactions, in which Freddie Mac has a significant variable interest, was approximately $339 million, consisting of the book value of our investments plus incremental guarantees of the senior interests issued by the trusts that are held by third parties.

NOTE 4: FINANCIAL GUARANTEES

Freddie Mac executes a variety of financial guarantees. Each of the principal types of such guarantees, including relevant qualitative and quantitative information associated with such items, is further discussed below.

Principal and Interest Guarantees of PCs and Structured Securities

As is further discussed in "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS," Freddie Mac issues two types of mortgage-related securities: PCs and Structured Securities. PCs represent undivided interests in pools of mortgage loans that are secured by either single-family or multifamily mortgage loans. Similarly, Structured Securities represent undivided interests in PCs or other mortgage-related securities that are issued by either Ginnie Mae or non-agency issuers. Freddie Mac guarantees the payment of principal and interest on all issued PCs and Structured Securities. Freddie Mac's guarantees related to Structured Securities include its guarantees on PCs or any non-Freddie Mac mortgage-related securities that underlie these Structured Securities.

Depending upon the nature by which we transfer PCs or Structured Securities to third parties in 2003, all such transfers, which totaled $713,249 million, are accounted for pursuant to the requirements of FIN 45 and SFAS 125/140. In either case, and upon completion of the transfer of PCs or Structured Securities to third parties, Freddie Mac will recognize the fair value of its obligation to make guarantee payments. Prior to 2003, all such transfers did not result in the recognition of a guarantee asset or guarantee obligation. The methods by which Freddie Mac accounts for such guarantees are further discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES."

The maximum potential amount of future principal payments Freddie Mac could be required to make in connection with the unpaid principal balance of all PCs and Structured Securities held by third parties totaled $752 billion and $730 billion at December 31, 2003 and 2002, respectively. Included in these amounts are $5.0 billion and $4.6 billion at December 31, 2003 and 2002, respectively, that pertains to guarantees related to multifamily housing revenue bonds that come in two principal forms. First, Freddie Mac provides a guarantee of the payment of principal and interest on tax-exempt multifamily housing revenue bonds that support pass-through certificates. These housing revenue bonds are collateralized by mortgage loans on low- and moderate-income multifamily housing projects. Secondly, Freddie Mac guarantees the payment of principal and interest related to low- and moderate- income multifamily mortgage loans that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds. Freddie Mac also provides a guarantee of the availability of funds totaling $4.5 billion and $3.7 billion, at December 31, 2003 and 2002, respectively, to enable the repurchase by others of tendered tax-exempt pass-through certificates and housing revenue bonds that are unable to be remarketed. The repurchased securities are then pledged to Freddie Mac as collateral for this funding until such time as the securities can be remarketed. There have been no payments made to date by Freddie Mac under this guarantee.

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

In connection with PCs or Structured Securities backed by single-family mortgage loans, Freddie Mac has maximum coverage totaling $28.9 billion and $33.0 billion in primary mortgage insurance as of December 31, 2003 and 2002, respectively, $5.2 billion and $4.1 billion in pool insurance and other credit enhancements as of December 31, 2003 and 2002, respectively, and $5.9 billion in recourse to lenders as of December 31, 2003 and 2002. In addition, $4.1 billion and $7.5 billion of issued Structured Securities relate to Ginnie Mae Certificates, which are backed by the full faith and credit of the U.S. government, as of December 31, 2003 and 2002, respectively. With respect to PCs backed by multifamily mortgage loans,

Freddie Mac has maximum combined credit enhancements totaling $9.5 billion and $2.3 billion at December 31, 2003 and 2002, respectively.

At December 31, 2003, Freddie Mac has a recognized Guarantee obligation for Participation Certificates on the consolidated balance sheets of $2.9 billion, which includes $0.8 billion of Day One Differences. At December 31, 2002, the Guarantee obligation for Participation Certificates totaled $1.4 billion. In addition, the company has a Reserve for Guarantee Losses on Participation Certificates that totalled $125 million and $88 million at December 31, 2003 and 2002, respectively for incurred credit losses that were recognized in conjunction with PCs and Structured Securities held by third parties.

Guarantees of Stated Final Maturity of Issued Structured Securities

Freddie Mac commonly issues Structured Securities with stated final maturities that are shorter than the stated maturity of the underlying mortgage loans. To the extent that assets that back such Structured Securities have not fully matured as of the stated final maturity date of such securities, Freddie Mac will sponsor an auction of the underlying assets to the extent a third party dealer who holds a par-based call option on such underlying assets does not exercise its option to purchase such underlying assets (an option which, if exercised, would provide a final set of redemption-based cash flows that Freddie Mac would pass through to investors in such Structured Securities). If an auction does occur, Freddie Mac would pass through proceeds received to investors of such Structured Securities. To the extent, however, that auction proceeds are insufficient to cover unpaid principal amounts due to investors in such Structured Securities, Freddie Mac is obligated to fund such principal. With respect to such guarantees of stated final maturity, Freddie Mac effectively writes a cash-settled put option to investors in such Structured Securities. Such guarantees are accounted for as derivative instruments pursuant to the requirements of SFAS 133.

As of December 31, 2003 and 2002, the maximum potential amount of payments Freddie Mac could be required to make under such guarantees was $8.4 billion and $13.3 billion, respectively, which represents the outstanding unpaid principal balance of the underlying mortgage loans. As of December 31, 2003 and 2002, the total fair value of recognized liabilities concerning such guarantees was $1.0 million and $5.8 million, respectively. The longest remaining contractual maturity of any outstanding written put option was 16 years and 28 years, as of December 31, 2003 and 2002, respectively; however, the actual terms may be significantly less than the contractual terms as the amortizing notional balance is linked to prepayable mortgage loans.

Indemnifications

In connection with various business transactions, Freddie Mac provides indemnification to counterparties for breaches of standard representations and warranties in contracts entered into in the normal course of business, based on an assessment that the risk of loss would be remote. It is difficult to estimate Freddie Mac's maximum exposure under these indemnification agreements since in many cases there are no stated or notional amounts included in the indemnification clauses. However, the contingencies triggering the obligation to indemnify have not occurred and are not expected to occur. Such representations and warranties pertain to hold harmless clauses, adverse changes in tax laws and potential claims from third parties related to items such as actual or alleged infringement of intellectual property. At December 31, 2003, there are fifteen identified transactions that contain intellectual property related indemnifications, as defined by FASB Staff Position No. 45-1, "Accounting for Intellectual Property Infringement Indemnifications under FASB Interpretation No. 45." Freddie Mac has not recorded any liabilities related to these indemnifications in its consolidated balance sheets as of December 31, 2003 and 2002.

Other Guarantees

Freddie Mac has guaranteed the performance of interest-rate swap contracts in two circumstances. First, as part of a resecuritization transaction, Freddie Mac transferred certain swaps and related assets to a third party. Freddie Mac guaranteed that interest income generated from the assets would be sufficient to cover the required payments under the interest-rate swap contracts. In the other circumstance, Freddie Mac guaranteed that a customer would perform under an interest-rate swap contract linked to the customer's variable rate mortgage. The maximum remaining terms of any of these guarantees at December 31, 2003 and 2002 was

27 years and 30 years, respectively; however, the actual terms may be significantly less than the contractual terms as the amortizing notional balance of the swaps is linked to prepayable mortgage loans.

Freddie Mac provides guarantees to reimburse servicers for premiums paid to acquire servicing in situations where Freddie Mac requires the original seller to repurchase the loan and the original seller is unable to perform under a separate agreement to reimburse the servicer for those servicing premiums. Freddie Mac's servicing related premium guarantees issued in 2003 all extend through 2008.

Freddie Mac entered into written put options that required the company to purchase certain floating-rate mortgage-related securities on specified dates and at specified interest rate spreads over an interest rate index. These written options, which effectively represent market value guarantees on financial assets held by Freddie Mac's counterparty to such options, were accounted for as derivatives and were recorded at fair value in the consolidated balance sheets. The contracts expired as of December 31, 2003.

Table 4.1 presents information about other guarantees extended by Freddie Mac for the periods presented.

Table 4.1 — Guarantees Extended by Freddie Mac

	Year Ended December 31, 2003		Year Ended December 31, 2002	
	Maximum potential amount of future payments	Carrying Value[1]	Maximum potential amount of future payments	Carrying Value[1]
	(dollars in millions)			
Swap payment guarantees[2]	$136	$—	$ 360	$—
Servicing released premiums[2]	151	—	137	—
Written put options on asset-backed securities[3]	—	—	564	1
Others[2][4]	1	—	2	—
Total	$288	$—	$1,063	$ 1

(1) Represents the carrying value of the liability, if any, recorded on Freddie Mac's consolidated balance sheets related to these guarantees.
(2) Freddie Mac has not established a liability on its consolidated balance sheets at December 31, 2003 and 2002 because it was not probable that it would be required to make payments under these contractual arrangements on those dates.
(3) Freddie Mac does not have any written put options on asset-backed securities outstanding at December 31, 2003.
(4) Represents a line of credit extended by Freddie Mac, which decreases over the contractual term.

NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO

Table 5.1 summarizes amortized cost, estimated fair values and corresponding gross unrealized gains and losses by major security type for available-for-sale mortgage-related securities held in the Retained portfolio and available-for-sale non-mortgage-related securities held in the investments portfolio at December 31, 2003, 2002 and 2001, respectively.

Table 5.1 — Available-For-Sale Securities

	December 31, 2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(dollars in millions)			
Retained portfolio				
Mortgage-related securities issued by:				
Freddie Mac	$378,956	$ 7,010	$(1,540)	$384,426
Fannie Mae	75,705	1,524	(385)	76,844
Ginnie Mae	2,785	134	(1)	2,918
Other	107,522	2,152	(265)	109,409
Obligations of states and political subdivisions	7,449	306	(26)	7,729
Total mortgage-related securities	572,417	11,126	(2,217)	581,326
Investments				
Non-mortgage-related securities:				
Asset-backed securities	16,209	394	(7)	16,596
Corporate debt securities	4,698	230	(4)	4,924
Obligations of states and municipalities	9,494	—	—	9,494
Commercial paper	150	—	—	150
Preferred stock	64	—	—	64
Total non-mortgage-related securities	30,615	624	(11)	31,228
Total available-for-sale securities	$603,032	$11,750	$(2,228)	$612,554

	December 31, 2002			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(dollars in millions)			
Retained portfolio				
Mortgage-related securities issued by:				
Freddie Mac	$316,464	$11,985	$ (454)	$327,995
Fannie Mae	79,203	2,770	(43)	81,930
Ginnie Mae	4,886	293	(4)	5,175
Other	71,104	2,755	(361)	73,498
Obligations of states and political subdivisions	7,424	337	(94)	7,667
Total mortgage-related securities	479,081	18,140	(956)	496,265
Investments				
Non-mortgage-related securities:				
Asset-backed securities	33,988	727	(21)	34,694
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	12,153	344	(4)	12,493
Corporate debt securities	9,742	385	(25)	10,102
Obligations of states and municipalities	6,639	2	—	6,641
Commercial paper	2,240	—	—	2,240
Preferred stock	244	5	—	249
Total non-mortgage-related securities	65,006	1,463	(50)	66,419
Total available-for-sale securities	$544,087	$19,603	$(1,006)	$562,684

	December 31, 2001			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(dollars in millions)			
Retained portfolio				
Mortgage-related securities issued by:				
Freddie Mac	$267,848	$ 5,030	$ (897)	$271,981
Fannie Mae	70,048	1,311	(264)	71,095
Ginnie Mae	5,619	226	(4)	5,841
Other	42,447	777	(153)	43,071
Obligations of states and political subdivisions	6,993	96	(156)	6,933
Total mortgage-related securities	392,955	7,440	(1,474)	398,921
Investments				
Non-mortgage-related securities:				
Asset-backed securities	26,016	288	(29)	26,275
Corporate debt securities	9,542	160	(53)	9,649
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	1,783	22	(55)	1,750
Obligations of states and political subdivisions	4,284	3	(1)	4,286
Other	12,847	3	—	12,850
Total non-mortgage-related securities	54,472	476	(138)	54,810
Total available-for-sale securities	$447,427	$ 7,916	$(1,612)	$453,731

In 2003 and 2002, Freddie Mac received proceeds of $142,167 million and $172,964 million, respectively, from the sale of securities from its available-for-sale portfolio, resulting in gross realized gains of $1,903 million and gross realized losses of $(1,077) million in 2003 and gross realized gains of $1,575 million and gross realized losses of $257 million in 2002. This information regarding gains and losses was not available prior to 2002 and therefore is presented on a net basis for 2001. In 2001, Freddie Mac received proceeds of $102,771 million from the sale of securities from its available-for-sale portfolio, resulting in net realized gains of $176 million.

On January 1, 2001, Freddie Mac transferred $36.3 billion of securities from available for sale to trading in conjunction with the implementation of SFAS 133, resulting in gross unrealized gains of $105 million and gross unrealized losses of $384 million being recorded to earnings.

Management has determined that the gross unrealized losses on the company's available-for-sale mortgage-related and non-mortgage related securities at December 31, 2003 are not other than temporary in nature. Management conducts periodic reviews to identify and evaluate investments that have indications of possible impairment. Impairment losses related to investments in debt securities are recognized in earnings if fair value is less than amortized cost and the decline is considered other than temporary. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for additional information about the company's impairment accounting policies.

Table 5.2 below shows the fair value of available-for-sale securities in a gross unrealized loss position at December 31, 2003:

Table 5.2 — Available-For-Sale Securities in an Unrealized Loss Position at December 31, 2003

	Less than 12 months		12 months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(dollars in millions)					
Retained portfolio						
Mortgage-related securities issued by:						
Freddie Mac	$133,679	$(1,486)	$ 7,376	$ (54)	$141,055	$(1,540)
Fannie Mae	29,011	(372)	407	(13)	29,418	(385)
Ginnie Mae	317	(1)	6	—	323	(1)
Other	34,080	(233)	5,453	(32)	39,533	(265)
Obligations of states and political subdivisions	660	(12)	269	(14)	929	(26)
Total mortgage related-securities	197,747	(2,104)	13,511	(113)	211,258	(2,217)
Investments						
Non-mortgage related securities:						
Asset-backed securities	1,569	(6)	406	(1)	1,975	(7)
Corporate debt securities	249	(2)	436	(2)	685	(4)
Obligations of states and political subdivisions	402	—	—	—	402	—
Commercial Paper	64	—	—	—	64	—
Total non-mortgage related securities	2,284	(8)	842	(3)	3,126	(11)
Total	$200,031	$(2,112)	$14,353	$(116)	$214,384	$(2,228)

The unrealized losses on available-for-sale securities as of December 31, 2003 of $2,228 million noted in Table 5.1 and Table 5.2, relate to approximately 56 thousand individual lots representing approximately 8 thousand separate securities. Freddie Mac routinely purchases multiple lots of individual securities at different points in time and at different costs. The company determines gross unrealized gains and losses by specifically identifying investment positions at the lot level and, thus, Freddie Mac often holds several lots of one security including both unrealized gain and unrealized loss positions, depending upon the amortized cost of the specific lot.

The following is management's analysis as to why each type of available-for-sale mortgage-related security in an unrealized loss position is not considered other-than-temporarily impaired:

- **Freddie Mac securities:** The unrealized losses on Freddie Mac securities are primarily a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost has not met the company's criteria that are used to indicate other-than-temporary impairment as described in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES." The company reviews the estimated credit exposure of the mortgages that underlie these securities. As a result of this review, management has determined that these securities are not other than temporarily impaired. See "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" for further information on our estimates of credit exposure and credit support.
- **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 a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost has not met the company's objective criteria that are used to indicate other-than-temporary impairment. The issuer guarantees related to these securities have led management to conclude that any credit risk is minimal.
- **Other securities in the Retained Portfolio:** The unrealized losses on the private-label mortgage-related securities included in Other are principally a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost has not met the company's objective criteria that are used to indicate other-than-temporary impairment. These securities are all investment grade (*i.e.*, rated BBB or better on a Standard & Poor's ("S&P") equivalent scale).

Table 5.3 summarizes the estimated fair values by major security type for trading securities at December 31, 2003, 2002 and 2001, respectively.

Table 5.3 — Trading Securities

	December 31,		
	2003 Fair Value	2002 Fair Value	2001 Fair Value
	(dollars in millions)		
Retained portfolio			
Mortgage-related securities issued by:			
Freddie Mac	$17,590	$28,535	$40,592
Fannie Mae	586	519	722
Ginnie Mae	24	50	86
Total	18,200	29,104	41,400
Investments			
Mortgage-related securities issued by:			
Freddie Mac	$17,266	$20,244	$20,220
Fannie Mae	15,052	11,029	6,099
Ginnie Mae	490	1,062	875
Other	9	31	—
Total	32,817	32,366	27,194
Non-mortgage-related securities:			
Asset-backed securities	$ 52	$ 96	$ 22
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	479	1,004	165
Mutual funds	—	540	1,194
Commercial paper	341	479	158
Corporate debt securities	437	229	—
Debt securities issued by foreign governments	5	4	—
Other	—	57	—
Total	1,314	2,409	1,539
Total trading securities	$52,331	$63,879	$70,133

The portion of Gains (losses) on investment activity that relates to trading securities still held in the trading portfolio at December 31, 2003, 2002 and 2001 is $(402) million, $1,293 million and $359 million, respectively.

At December 31, 2003, Freddie Mac held securities in its Retained portfolio and investments portfolio issued by two highly-rated issuers, Fannie Mae and Ginnie Mae, that individually exceed 10 percent of Stockholders' equity. Table 5.4 details the aggregate fair value of the securities from each issuer and the aggregate fair value of the company's holdings of each issuer's securities as a percent of Stockholders' equity.

Table 5.4 — Issuers Greater than 10 Percent of Stockholders' Equity

	December 31, 2003	
	Fair Value	% Equity
	(dollars in millions)	
Fannie Mae[1]	$92,482	294%
Ginnie Mae[1]	3,432	11
Total	$95,914	305%

(1) Represents mortgage-related securities guaranteed by each entity, regardless of whether these securities have been issued through a separate trust or not.

Table 5.5 summarizes, by major security type, the remaining contractual maturities of available-for-sale mortgage-related and non-mortgage-related securities at December 31, 2003.

Table 5.5 — Maturities

December 31, 2003	Due 1 year or less	Due after 1 through 5 years	Due after 5 through 10 years	Due after 10 years	Total
			(dollars in millions)		
AVAILABLE FOR SALE					
Retained portfolio					
Total mortgage-related securities[1]					
Amortized Cost	$ 33	$ 6,468	$24,558	$541,358	$572,417
Fair Value	33	6,709	25,715	548,869	581,326
Investments					
Non-mortgage-related securities					
Asset-backed securities[1]					
Amortized Cost	7	10,363	5,629	210	16,209
Fair Value	7	10,566	5,812	211	16,596
Corporate debt securities					
Amortized Cost	608	3,951	30	109	4,698
Fair Value	610	4,161	32	121	4,924
Obligations of states and political subdivisions					
Amortized Cost	571	92	173	8,658	9,494
Fair Value	571	92	173	8,658	9,494
Commercial paper:					
Amortized Cost	150	—	—	—	150
Fair Value	150	—	—	—	150
Preferred stock					
Amortized Cost	—	64	—	—	64
Fair Value	—	64	—	—	64
Total non-mortgage-related securities					
Amortized Cost	1,336	14,470	5,832	8,977	30,615
Fair Value	1,338	14,883	6,017	8,990	31,228
Total available for sale					
Amortized Cost	$1,369	$20,938	$30,390	$550,335	$603,032
Fair Value	$1,371	$21,592	$31,732	$557,859	$612,554

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

Table 5.6 presents the changes in AOCI, net of taxes, related to available-for-sale securities. The Unrealized holding (losses) gains, net of tax (benefit) expense line represents the net mark-to-fair value adjustments recorded on available-for-sale securities throughout the year after the effects of the company's statutory tax rate of 35 percent. The Reclassification adjustment for realized (gains) losses included in net income, net of tax (expense) represents the amount of those mark-to-fair value adjustments after the effects of the company's statutory tax rate of 35 percent that have been recognized in earnings due to a sale of an available-for-sale security or the recognition of an impairment loss.

Table 5.6 — AOCI, Net of Taxes, Related to Available-for-Sale Securities

	Year Ended December 31,		
	2003	2002	2001
	(dollars in millions)		
Beginning balance	$12,217	$ 4,200	$1,084
Net unrealized investment gains (losses) during the period:			
Unrealized holding (losses) gains, net of tax (benefit) expense of $(3,107), $4,583 and $1,723, respectively	(5,770)	8,512	3,200
Reclassification adjustment for realized (gains) losses included in net income, net of tax (expense) of $(53), $(267), and $(45), respectively[1]	(98)	(495)	(84)
Ending balance	$ 6,349	$12,217	$4,200

(1) Includes impairment losses on securities where the decline in fair value is considered to be other than temporary of $438 million, $422 million and $228 million, net of tax for the years ended December 31, 2003, 2002 and 2001, respectively.

Secured Financing Transactions

Freddie Mac enters into several types of secured financing transactions, including interest-rate swap agreements, secured borrowings and secured lendings. Repurchase transactions are treated as secured borrowings, because Freddie Mac sells securities to a counterparty for cash and will purchase the same collateral back at a future date. Securities purchased under agreements to resell (reverse repurchase agreements) are effectively collateralized lending transactions in which Freddie Mac purchases a security with an agreement to sell back the same security at a specified time.

Freddie Mac's counterparties are required to post collateral for reverse repurchase transactions and interest-rate swap agreements. Even though it is Freddie Mac's practice not to repledge assets held as collateral, based on master agreements, most of the collateral can be repledged. At December 31, 2003 and 2002, the fair value amount of collateral held by Freddie Mac under secured lending transactions and interest-rate swap agreements that was available for repledging was approximately $8.2 billion and $6.5 billion, respectively.

Freddie Mac is also required to post collateral for margin requirements with some custodians in connection with secured financing and daily trade activities. Based on agreements between Freddie Mac and the custodians, as illustrated in Table 5.7, some collateral may be permitted by contract to be repledged by the custodian. Freddie Mac has parenthetically disclosed on the consolidated balance sheets the fair value of assets pledged as collateral with the right to repledge. Table 5.7 summarizes all assets pledged as collateral by the company including pledged assets that the secured party can repledge and those that cannot be repledged.

Table 5.7 — Collateral Pledged

	Year Ended December 31,	
	2003	2002
	(dollars in millions)	
Assets pledged with ability for secured party to repledge (parenthetically disclosed on the consolidated balance sheets)		
Available for sale	$282	$ 717
Trading	61	153
Subtotal	343	870
Assets pledged without ability for secured party to repledge		
Available for sale	558	627
Trading	28	8
Subtotal	586	635
Total assets pledged	$929	$1,505

Cash and Cash Equivalents

Table 5.8 summarizes the components of Cash and cash equivalents for the years ended December 31, 2003 and 2002, respectively.

Table 5.8 — Cash and Cash Equivalents

	December 31,	
	2003	2002
	(dollars in millions)	
Interest-bearing[1]	$23,100	$10,729
Non-interest-bearing	42	63
Total	$23,142	$10,792

(1) Includes collateral that Freddie Mac holds when its exposure to its derivative counterparties exceeds mutually agreed upon limits. Interest earned on the collateral is paid to the counterparties at the contractual rate, while Freddie Mac retains any interest earned above the contractual rate.

NOTE 6: LOAN LOSS RESERVES

Freddie Mac maintains separate loan loss reserves for mortgage loans in the Retained portfolio that it classifies as held for investment and for credit-related losses associated with certain mortgage loans that underlie PCs held by third parties.

Table 6.1 summarizes loan loss reserve activity during 2003, 2002 and 2001.

Table 6.1 — Detail of Loan Loss Reserves Balance

	December 31,								
	2003			2002			2001		
	Reserves related to:			Reserves related to:			Reserves related to:		
	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves
	(dollars in millions)								
Beginning balance	$ 177	$ 88	$ 265	$ 103	$121	$ 224	$ 100	$129	$ 229
Provision for credit losses[1]	102	(92)	10	161	(33)	128	40	(8)	32
Charge-offs[1]	(224)	—	(224)	(171)	—	(171)	(129)	—	(129)
Recoveries[1]	119	—	119	84	—	84	92	—	92
Adjustment for change in accounting[2]	—	110	110	—	—	—	—	—	—
Transfers-in during the period[3]	—	19	19	—	—	—	—	—	—
Ending balance	$ 174	$125	$ 299	$ 177	$ 88	$ 265	$ 103	$121	$ 224

(1) It is Freddie Mac's practice to purchase mortgage loans from the pools that underlie PCs at the point the mortgage loan is identified as being 120 days past due. Upon repurchase, that portion of amounts classified in Reserve for guarantee losses on Participation Certificates that relates to a purchased loan is reclassified to Reserve for losses on mortgage loans held for investment. Given that all credit losses related to off-balance sheet PCs are preceded by the purchase of a delinquent mortgage loan from the PC pool, all charge-offs or recoveries are presented in the Retained Mortgages columns above.
(2) On January 1, 2003, that portion of recognized guarantee obligations that was attributable to estimated incurred losses on outstanding PCs or Structured Securities, or $110 million, was reclassified to Reserve for guarantee losses on Participation Certificates.
(3) Represents estimated losses that were incurred in 2003 related to PCs and Structured Securities transferred to third parties in 2003.

Impaired Loans

Total loan loss reserves, as presented in Table 6.1, consists of a specific valuation allowance related to impaired loans, which are presented in Table 6.2, and an additional reserve for other probable losses, which equaled $289 million, $240 million and $218 million as of December 31, 2003, 2002 and 2001, respectively. The company's recorded investment in impaired loans and the related valuation allowance are summarized in Table 6.2.

Table 6.2 — Impaired Loans[1]

	December 31,								
	2003			2002			2001		
	Recorded Investment[2]	Specific Reserve	Net Investment	Recorded Investment[2]	Specific Reserve	Net Investment	Recorded Investment[2]	Specific Reserve	Net Investment
	(dollars in millions)								
Impaired loans having:									
Related-valuation allowance	$ 60	$ (10)	$ 50	$ 169	$(25)	$ 144	$ 77	$ (6)	$ 71
No-related-valuation allowance	2,309	—	2,309	2,077	—	2,077	1,612	—	1,612
Total	$2,369	$ (10)	$2,359	$2,246	$(25)	$2,221	$1,689	$ (6)	$1,683

(1) Single-family impaired loans include performing and non-performing TDRs. Multifamily impaired loans are defined as performing and non-performing TDR loans, loans 60 days or more delinquent unless credit enhanced, and certain mortgage loans with real estate collateral values less than the outstanding unpaid principal balances. For more details on multifamily impaired loans, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES."
(2) Recorded Investment includes the unpaid principal balance of mortgage loans plus other basis adjustments, which are modifications to their carrying value.

For the years ended December 31, 2003, 2002 and 2001, the average recorded investment in impaired loans was $2,330 million, $2,029 million and $1,577 million, respectively.

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 $16 million, $22 million and $20 million for the years ended December 31, 2003, 2002

and 2001, respectively. For single-family performing and non-performing loans, Freddie Mac recognizes interest income on an accrual basis and establishes reserves for estimated accrued, but uncollectible, interest for these loans as of the consolidated balance sheet dates. Gross interest income on impaired single-family loans totaled $160 million, $129 million and $104 million for the years ended December 31, 2003, 2002 and 2001, respectively.

Delinquency Rates

Table 6.3 summarizes the delinquency rates for Freddie Mac's total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates at December 31, 2003, 2002 and 2001.

Table 6.3 — Delinquency Performance[1]

	December 31,		
	2003	**2002**	**2001**
Delinquencies, end of period			
Single-family:[2]			
Credit-enhanced portfolio[3]	2.96%	2.07%	1.30%
Non-credit-enhanced portfolio	0.27%	0.28%	0.29%
Total portfolio[3]	0.86%	0.77%	0.62%
Multifamily[4]	0.05%	0.13%	0.15%

(1) Based on the total mortgage portfolio, excluding both non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.
(2) Based on the number of mortgages 90 days or more delinquent or in foreclosure.
(3) Includes alternative collateral deals.
(4) Based on net carrying value of mortgages 60 days or more delinquent or in foreclosure.

NOTE 7: REAL ESTATE OWNED

Table 7.1 provides a summary of Freddie Mac's REO activity.

Freddie Mac obtains REO properties when it is the highest bidder at foreclosure sales of properties that collateralize non-performing single-family and multifamily mortgage loans owned by the company. Upon acquiring single-family properties, Freddie Mac establishes 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, Freddie Mac 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 three years ended December 31, 2003, the weighted average holding period for single-family disposed properties was less than one year and the weighted average holding period for multifamily disposed REO properties was about two years.

Table 7.1 — Real Estate Owned

	REO, Gross	Valuation Allowance	REO, Net
	(dollars in millions)		
Balance, December 31, 2000	$ 393	$ (35)	$ 358
Additions	910	(50)	860
Dispositions and write-downs	(798)	27	(771)
Balance, December 31, 2001	505	(58)	447
Additions	1,197	(70)	1,127
Dispositions and write-downs	(1,032)	52	(980)
Balance, December 31, 2002	670	(76)	594
Additions	1,663	(93)	1,570
Dispositions and write-downs	(1,422)	53	(1,369)
Balance, December 31, 2003	$ 911	$(116)	$ 795

Freddie Mac recognized gains of $3 million, $22 million and $12 million on REO dispositions for the years ended December 31, 2003, 2002 and 2001, respectively, which are included in REO operations income (expense).

NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS

Debt securities are classified as either Due within one year or Due after one year based on their remaining contractual maturity. Table 8.1 summarizes the balances and effective interest rates at December 31, 2003 and 2002 for debt securities, as well as subordinated borrowings.

Table 8.1 — Total Debt Securities, Net

	December 31,			
	2003		2002	
	Balance, Net[2]	Effective Rate[3]	Balance, Net[2]	Effective Rate[3][4]
	(dollars in millions)			
Senior debt, due within one year:				
Short-term debt securities[1]	$212,035	1.10%	$194,044	1.58%
Current portion of long-term debt	83,227	3.61	50,385	4.78
Senior debt, due within one year	295,262	1.81	244,429	2.24
Senior debt, due after one year	438,738	4.34	415,662	4.94
Subordinated debt, due after one year	5,613	6.15	5,605	6.15
Senior and subordinated debt, due after one year	444,351	4.36%	421,267	4.96%
Total debt securities, net	$739,613		$665,696	

(1) See "Table 8.2 — Senior Debt, Due Within One Year" for further information regarding Freddie Mac's short-term debt securities.
(2) Includes discounts and premiums. Current portion of long-term debt, and senior and subordinated debt, due after one year, also include hedging-related and other basis adjustments.
(3) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of hedging-related and other basis adjustments.
(4) Effective rates previously reported for December 31, 2002 have been revised.

Freddie Mac finances the purchase of mortgage loans and mortgage-related securities primarily through the issuance of Senior debt and Subordinated debt.

Senior Debt, Due Within One Year

As indicated in Table 8.2, a majority of Senior debt, due within one year (excluding current portion of long-term debt) consisted of discount notes and medium-term notes as of December 31, 2003 and 2002, respectively. Approximately 97 percent and 99 percent of the unpaid principal balances of these discount notes and medium-term notes outstanding as of December 31, 2003 and 2002, respectively, have been issued on a discounted basis, paying only principal at maturity. Discount notes and medium-term notes are unsecured general obligations. Securities sold under agreements to repurchase are effectively collateralized borrowing transactions where Freddie Mac sells securities with an agreement to repurchase such securities. These agreements require the underlying securities to be delivered to the dealers who arranged the transactions. See "NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO" for more information. Federal funds purchased are unsecuritized borrowings from commercial banks that are members of the Federal Reserve System.

Table 8.2 provides additional information related to Freddie Mac's debt securities due within one year.

Table 8.2 — Senior Debt, Due Within One Year

	2003				
	As of December 31,		Average Outstanding During the Year		
	Balance, Net	Weighted Average Effective Rate[1]	Balance	Weighted Average Effective Rate[2]	Maximum Balance Outstanding at Any Month End
	(dollars in millions)				
Discount notes	$188,309	1.12%	$207,374	1.21%	$264,363
Medium-term notes	5,300	1.18	1,243	1.32	5,300
Securities sold under agreements to repurchase and Federal funds purchased	1,611	0.96	1,128	1.20	8,296
Swap collateral borrowings	16,082	0.90	11,694	1.13	16,082
Securities sold, not yet purchased	733				
Subtotal	212,035				
Current portion of long-term debt	83,227				
Total debt securities, due within one year	$295,262				

	2002				
	As of December 31,		Average Outstanding During the Year		
	Balance, Net	Weighted Average Effective Rate[1]	Balance	Weighted Average Effective Rate[2]	Maximum Balance Outstanding at Any Month End
	(dollars in millions)				
Discount notes	$163,202	1.61%	$180,889	2.02%	$211,388
Medium-term notes	1,015	2.07	5,528	2.39	8,161
Securities sold under agreements to repurchase and Federal funds purchased	15,262	1.08	13,882	1.39	21,472
Swap collateral borrowings	8,209	0.66	4,630	1.17	8,209
Securities sold, not yet purchased	6,356				
Subtotal	194,044				
Current portion of long-term debt	50,385				
Total debt securities, due within one year	$244,429				

	2001				
	As of December 31,		Average Outstanding During the Year		
	Balance, Net	Weighted Average Effective Rate[1]	Balance	Weighted Average Effective Rate[2]	Maximum Balance Outstanding at Any Month End
	(dollars in millions)				
Discount notes	$219,656	2.44%	$191,478	4.26%	$219,656
Medium-term notes	6,730	2.91	9,150	4.98	13,638
Securities sold under agreements to repurchase and Federal funds purchased	4,548	1.52	5,029	3.15	8,096
Swap collateral borrowings	1,932	3.67	1,747	4.06	2,257
Securities sold, not yet purchased	12,856				
Subtotal	245,722				
Current portion of long-term debt	18,505				
Total debt securities, due within one year	$264,227				

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

Senior and Subordinated Debt, Due After One Year

Table 8.3 summarizes Freddie Mac's Senior and Subordinated debt, due after one year at December 31, 2003 and 2002.

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

		December 31,			
		2003		2002	
	Contractual Maturity[1]	Balance Outstanding[2]	Interest Rate(s)	Balance Outstanding[2]	Interest Rate(s)
		(dollars in millions)			
Senior debt, due after one year[3]:					
Fixed-rate:					
Callable[4]	2005 — 2028	$159,939	1.30% — 9.00%	$135,923	1.77% — 8.29%
Non-callable	2005 — 2022	6,460	1.00% — 8.12%	7,857	1.00% — 9.00%
U.S. dollar-denominated Reference Notes® securities	2005 — 2032	181,901	1.50% — 7.00%	196,454	2.88% — 7.00%
€Reference Notes® securities	2005 — 2013	24,954	3.50% — 5.75%	33,041	4.50% — 5.75%
Other	2008 — 2014	43	12.10% — 12.90%	64	7.76% — 12.90%
Floating-rate:					
Callable[5]	2005 — 2029	28,412	Various	20,189	Various
Non-callable[6]	2005 — 2026	16,403	Various	723	Various
Zero-coupon:					
Callable[7]	2007 — 2033	6,608	0%	8,036	0%
Non-callable	2005 — 2034	1,723	0%	1,715	0%
Total senior debt, due after one year		426,443		404,002	
Subordinated debt, due after one year:[3]					
Fixed-rate[8]	2011 — 2016	5,545	5.25% — 8.25%	5,543	5.25% — 8.25%
Zero-coupon	2019	68	0%	62	0%
Total subordinated debt, due after one year		5,613		5,605	
Foreign-currency-related and hedging-related basis adjustments		12,295		11,660	
Total senior and subordinated debt, due after one year		$444,351		$421,267	

(1) Represents contractual maturities at December 31, 2003.
(2) Represents unpaid principal balance of long-term debt securities and subordinated borrowings, net of associated discounts or premiums.
(3) For debt denominated in a currency other than the US 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 Notes[SM] and Freddie Notes[SM] of $11,041 million and $10,208 million as of December 31, 2003 and 2002, respectively. These debt instruments represents medium-term notes that permit persons acting on behalf of deceased beneficial owners to require Freddie Mac to repay principal prior to their contractual maturity date.
(5) Includes callable Estate Notes[SM] and Freddie Notes[SM] of $4,132 million and $2,214 million as of December 31, 2003 and 2002, respectively. See related footnote (4) above concerning the nature of these debt instruments.
(6) Includes medium-term notes of $700 million and $300 million as of December 31, 2003 and 2002, respectively, which are repayable in whole or in part at the option of the beneficial owner, acting through the holder, on or after November 22, 2002 and prior to November 20, 2007 at 100% of the principal amount, plus accrued interest.
(7) Includes callable Estate Notes[SM] and Freddie Notes[SM] of $0 million and $21,954 million as of December 31, 2003 and 2002, respectively. See related footnote (4) above concerning the nature of these debt instruments.
(8) Includes callable subordinated debt of $3,490 million and $3,489 million as of December 31, 2003 and 2002, respectively.

A portion of Freddie Mac's long-term debt is callable. Callable debt gives Freddie Mac the option to redeem the debt security at either a specified call date or at any time on or after a specified call date. Table 8.4 summarizes the maturities, balances and effective interest rates at December 31, 2003 for callable debt (including current portion of callable debt and callable debt due after one year) by estimated call period.

Table 8.4 — Callable Debt, Due After One Year (including current portion of callable debt)

Estimated Call Period	Contractual Maturity	Balance Outstanding[1]	Effective Rate[2]
		(dollars in millions)	
2004	2004 — 2018	$ 42,469	3.30%
2005	2005 — 2018	23,607	2.28
2006	2006 — 2021	32,171	2.69
2007	2007 — 2018	13,454	3.35
2008	2008 — 2017	24,999	3.46
Thereafter	2009 — 2033	83,285	5.06
Total		$219,985	3.79%

(1) Represents unpaid principal balance of callable long-term debt securities and subordinated borrowings. However, callable zero-coupon debt is reflected on a net basis (*i.e.*, net of associated discounts of $34,054 million).
(2) Represents the weighted-average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs but excludes the amortization of hedging-related and other basis adjustments.

Table 8.5 summarizes the contractual maturities of long-term debt securities (including current portion of long-term debt) and subordinated borrowings outstanding at December 31, 2003, assuming callable debt is paid at contractual maturity.

Table 8.5 — Senior and Subordinated Debt, Due After One Year (including current portion of long-term debt)

Annual Maturities	Contractual Maturity[1][2]
	(dollars in millions)
2004	$ 80,610
2005	90,840
2006	73,290
2007	36,958
2008	50,675
Thereafter	218,502
Total[1]	550,875
Net premiums, discounts, and foreign-currency-related and hedging-related basis adjustments[2][3]	(23,297)
Senior and subordinated debt, due after one year, including current portion of long-term debt	$527,578

(1) Represents unpaid principal balance of long-term debt securities and subordinated borrowings.
(2) 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 Net premiums, discounts, and foreign-currency-related and hedging-related basis adjustments.
(3) Represents unamortized premiums, discounts, and hedging-related and other basis adjustments. It includes discounts of $37,870 million associated with callable and non-callable zero-coupon debt.

Freddie Mac incurred losses of $1,775 million, $674 million and $356 million on the repurchase of approximately $27.3 billion, $20.3 billion and $4.7 billion in principal amount of debt outstanding in 2003, 2002 and 2001, respectively.

NOTE 9: STOCKHOLDERS' EQUITY

Preferred Stock

During 2003, Freddie Mac completed no preferred stock offerings (see "Table 9.1 — Preferred Stock" for more information). All 17 classes of preferred stock outstanding at December 31, 2003 have a par value of $1 per share, and are redeemable, on specified dates, at the company's option at their redemption price (or redemption value) plus dividends accrued through the redemption date. In addition, all 17 classes of preferred stock are perpetual and non-cumulative, and carry no significant voting rights or rights to purchase additional Freddie Mac stock or securities. Costs incurred in connection with the issuance of preferred stock are charged to "Additional paid-in capital."

Table 9.1 provides a summary of Freddie Mac's preferred stock outstanding at December 31, 2003.

Table 9.1 — Preferred Stock

	Issue Date	Shares Authorized	Shares Outstanding	Total Par Value	Redemption Price per Share	Total Outstanding Balance[1]	Redeemable[10] On or After	NYSE Symbol[2]
		(shares and dollars in millions, except redemption price per share)						
1996 Variable-rate[3]	April 26, 1996	5.00	5.00	$ 5.00	$50.00	$ 250	June 30, 2001	FRE.prB
6.14%	June 3, 1997	12.00	12.00	12.00	50.00	600	June 30, 2002	FRE.prD
5.81%	October 27, 1997	3.00	3.00	3.00	50.00	150	October 27, 1998	(9)
5%	March 23, 1998	8.00	8.00	8.00	50.00	400	March 31, 2003	FRE.prF
1998 Variable-rate[4]	September 23 and 29, 1998	4.40	4.40	4.40	50.00	220	September 30, 2003	FRE.prG
5.1%	September 23, 1998	8.00	8.00	8.00	50.00	400	September 30, 2003	FRE.prH
5.3%	October 28, 1998	4.00	4.00	4.00	50.00	200	October 30, 2000	(9)
5.1%	March 19, 1999	3.00	3.00	3.00	50.00	150	March 31, 2004	(9)
5.79%	July 21, 1999	5.00	5.00	5.00	50.00	250	June 30, 2009	FRE.prK
1999 Variable-rate[5]	November 5, 1999	5.75	5.75	5.75	50.00	288	December 31, 2004	FRE.prL
2001 Variable-rate[6]	January 26, 2001	6.50	6.50	6.50	50.00	325	March 31, 2003	FRE.prM
2001 Variable-rate[7]	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	172	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[8]	May 30, 2001	4.02	4.02	4.02	50.00	201	June 30, 2003	FRE.prQ
5.7%	October 30, 2001	6.00	6.00	6.00	50.00	300	December 31, 2006	FRE.prR
5.81%	January 29, 2002	6.00	6.00	6.00	50.00	300	March 31, 2007	(9)
Total		92.17	92.17	$92.17		$4,609		

(1) Amounts stated at redemption value.
(2) Preferred Stock is listed on the New York Stock Exchange, unless otherwise noted.
(3) The dividend rate resets quarterly and is equal to the sum of the three-month London Interbank Offered Rate ("LIBOR") plus one percent divided by 1.377, and is capped at 9.00 percent.
(4) The dividend rate resets quarterly and is equal to the sum of the three-month LIBOR rate plus one percent divided by 1.377, and is capped at 7.50 percent.
(5) Initial dividend rate is 5.97 percent per annum through December 31, 2004. Dividend rate resets on January 1, 2005 and on January 1 every five years thereafter based on a five-year constant maturity Treasury ("CMT") rate which is capped at 11.00 percent. Optional redemption on December 31, 2004 and on December 31 every five years thereafter.
(6) Dividend rate resets on April 1 every two years after April 1, 2003 based on the 2-year CMT rate plus .10 percent and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every two years thereafter.
(7) Dividend rate resets on April 1 every year based on the 12-month LIBOR rate minus .20 percent and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every year thereafter.
(8) Dividend rate resets on July 1 every two years after July 1, 2003 based on the 2-year CMT rate plus .20 percent and is capped at 11.00 percent. Optional redemption on June 30, 2003 and on June 30 every two years thereafter.
(9) Not listed on any exchange.
(10) As long as the capital monitoring framework established by the Office of Federal Housing Enterprise Oversight ("OFHEO") in January 2004 remains in effect, any preferred stock redemption will require prior approval by OFHEO. See "NOTE 10: REGULATORY CAPITAL" to the consolidated financial statements for more information.

Dividends Declared

Table 9.2 summarizes the cash dividends declared per share on Freddie Mac's common and preferred stock.

Table 9.2 — Cash Dividends Declared

	Year Ended December 31,		
	2003	2002	2001
Common:	$1.04	$0.88	$0.80
Preferred:			
1996 Variable-rate	0.83	1.07	1.98
6.125%[1]	—	0.46	3.06
6.14%	3.07	3.07	3.07
5.81% (1997 issue)	2.91	2.91	2.91
5%	2.50	2.50	2.50
1998 Variable-rate	0.83	1.07	1.98
5.1% (1998 issue)	2.55	2.55	2.55
5.3%	2.65	2.65	2.65
5.1% (1999 issue)	2.55	2.55	2.55
5.79%	2.90	2.90	2.90
1999 Variable-rate	2.99	2.99	2.99
January 2001 Variable-rate	1.22	2.41	2.23
March 2001 Variable-rate	0.79	1.64	1.77
5.81% (2001 issue)	2.91	2.91	2.24
6%	3.00	3.00	1.75
May 2001 Variable-rate	1.52	2.24	1.31
5.7%	2.85	2.85	0.48
5.81% (2002 issue)	2.91	2.67	—

(1) Redeemed at a price of $50.46 per share, which includes the face amount of $50.00 per share plus $0.46 of dividends that were earned through February 24, 2002, the redemption date.

Common Stock Repurchase Program

In September 1997, Freddie Mac's Board of Directors authorized the company to repurchase up to five percent, or approximately 34 million shares, of its common stock outstanding as of September 5, 1997. Under this authorization, Freddie Mac repurchased no outstanding shares in 2003, 9.1 million outstanding shares in 2002 and no outstanding shares in 2001. Common stock repurchases are considered (assuming timely financial reporting) when we are adequately capitalized and attractive investment opportunities are not available. Under OFHEO's January 29, 2004 framework for monitoring Freddie Mac's capital, Freddie Mac is currently required to obtain prior written approval from the Director of OFHEO before engaging in certain capital transactions, including the repurchase of any shares of common stock, the redemption of any preferred stock, or payment of preferred stock dividends above stated contractual rates.

NOTE 10: REGULATORY CAPITAL

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("GSE Act") established risk-based, minimum and critical capital standards for Freddie Mac and Fannie Mae.

The risk-based capital standard determines the amount of capital that Freddie Mac must hold to absorb projected losses flowing from future adverse interest-rate and credit-risk conditions specified by the GSE Act, plus 30 percent mandated by the GSE Act to cover management and operations risk. The risk-based capital standard is based on stress test results calculated under two interest-rate scenarios prescribed by the GSE Act, one in which 10-year Treasury yields rise 75 percent (up-rate scenario) and one in which they fall 50 percent (down-rate scenario). Changes in both scenarios are capped generally at 600 basis points. The risk-based capital requirement for Freddie Mac is the amount of Total capital that would enable it to absorb the stress test losses in whichever scenario is more adverse, plus 30 percent of that amount to cover management and operations risk. 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. 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 perpetual preferred stock, additional paid-in capital and retained earnings as measured under GAAP.

The minimum capital standard requires Freddie Mac to hold an amount of Core capital that is approximately the sum of 2.50 percent of aggregate on-balance sheet assets, as measured under GAAP and 0.45 percent of other aggregate off-balance sheet obligations. As discussed below, in 2004 OFHEO implemented a framework for monitoring our capital adequacy which includes a targeted capital surplus of 30 percent of Freddie Mac's minimum capital requirement.

The critical capital standard requires Freddie Mac to hold an amount of Core capital that is approximately the sum of 1.25 percent of aggregate on-balance sheet assets, as measured under GAAP, and 0.25 percent of other aggregate off-balance sheet obligations.

OFHEO is required to classify Freddie Mac's capital adequacy not less than quarterly. Prior to the third quarter of 2002, the company was classified using the minimum and critical capital standards only. In the third quarter of 2002, OFHEO commenced quarterly classifications using the risk-based, minimum and critical capital standards.

To be classified as "adequately capitalized," Freddie Mac must meet both the risk-based and minimum capital standard. If Freddie Mac fails to meet the risk-based capital standard, it cannot be classified higher than "undercapitalized." Under OFHEO regulations, the company will be deemed "significantly undercapitalized" if it fails to meet the minimum capital requirement but exceeds the critical capital requirement. If Freddie Mac fails to meet the critical capital standard, Freddie Mac must be classified as "critically undercapitalized." OFHEO retains discretion to reduce Freddie Mac's capital classification by one level if OFHEO determines that Freddie Mac is engaging in conduct not approved by OFHEO that could result in a rapid depletion of Core capital or that the value of property subject to mortgage loans held or secured by Freddie Mac has decreased significantly.

OFHEO has never classified Freddie Mac as other than "adequately capitalized," the highest possible classification. When Freddie Mac is classified as adequately capitalized, the company can pay a dividend on its common or preferred stock without prior OFHEO approval so long as the payment would not decrease Total capital to an amount less than its risk-based capital level and would not decrease the company's Core capital to an amount less than the minimum capital level.

If Freddie Mac were classified as undercapitalized, the company would be prohibited from making a capital distribution (which includes common and preferred dividend payments, common stock repurchases and preferred stock redemptions) that would decrease its Core capital to an amount less than the minimum capital level. Freddie Mac also would be required to submit a capital restoration plan for OFHEO approval, which could adversely affect its ability to make capital distributions.

If Freddie Mac were classified as significantly undercapitalized, the company would be able to make a capital distribution only if OFHEO determined that the distribution satisfied certain statutory standards.

Under these circumstances, Freddie Mac would be prohibited from making any capital distribution that would decrease its Core capital to less than the critical capital level, and OFHEO also could take action to limit Freddie Mac's growth, require it to acquire new capital or restrict it from activities that create excessive risk. Freddie Mac also would be required to submit a capital restoration plan for OFHEO approval, which could adversely affect its ability to make capital distributions.

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

Factors that may adversely affect the adequacy of Freddie Mac's regulatory capital include declines in GAAP income, increases in the company's risk profile, and changes in the economic environment, such as large interest-rate or implied volatility moves or house price declines. In particular, interest-rate or implied volatility changes can affect the amount of Freddie Mac's Core capital, even if Freddie Mac is 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.

Table 10.1 summarizes the company's regulatory capital requirements and surpluses at December 31, 2003 and 2002. Amounts for 2003 are as reported to OFHEO.

Table 10.1 — Regulatory Capital Requirements

	December 31,	
	2003	2002
	(dollars in millions)	
Minimum capital requirement	$23,774	$22,339
Core capital[1][2]	32,985	28,990
Minimum capital surplus[1]	9,211	6,651
Critical capital requirement	12,097	11,369
Core capital[1][2]	32,985	28,990
Critical capital surplus[1]	20,888	17,621
Risk-based capital requirement[3]	5,426	4,743
Total capital[3][4]	33,436	24,222
Risk-based capital surplus[3]	28,010	19,479

(1) For 2003, Core capital and minimum and critical capital surpluses have been amended from amounts previously reported to OFHEO to incorporate adjustments reflected in our consolidated financial statements. The 2003 minimum and critical surplus amounts are estimates and have been revised to reflect a loss contingency reserve related to proceedings arising from the restatement. OFHEO is the authoritative source of the capital calculations that underlie the company's capital classifications. See "NOTE 13: LEGAL CONTINGENCIES" for further information.
(2) Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), par value of outstanding perpetual preferred stock, additional paid in capital and retained earnings, as determined in accordance with GAAP.
(3) Risk-based and Total capital amounts are those calculated by OFHEO prior to the issuance of our 2003 and 2002 financial results. OFHEO determined not to recalculate the risk-based capital amounts given that the minimum capital requirement remained the determining requirement for Freddie Mac's classification as adequately capitalized.
(4) Total capital includes Core capital and general reserves for mortgage and foreclosure losses.

On January 29, 2004, OFHEO announced the creation of a framework for monitoring Freddie Mac's capital due to the temporarily higher operational risk arising from the company's current inability to produce timely financial statements in accordance with GAAP. The framework includes a target capital surplus of 30 percent of Freddie Mac's minimum capital requirement, subject to certain conditions and variations; weekly monitoring; and prior approval of capital transactions, to verify that appropriate levels of capital are maintained. While OFHEO's framework includes stringent monitoring and imposes restrictions on share repurchases and other capital activities, Freddie Mac does not expect it to adversely affect its disciplined growth strategy in most scenarios. Had the target capital surplus been in effect at December 31, 2003, our estimated surplus in excess of the target would have been approximately $2.1 billion.

OFHEO's oversight of Freddie Mac's actions is intended to verify that capital used to support growth is reasonable given market conditions and the company's overall capital position. OFHEO will monitor Freddie Mac's estimated capital position on a weekly basis. A failure by Freddie Mac to meet the target capital surplus

would result in discussions between Freddie Mac and OFHEO concerning the reason for such failure. If OFHEO were to determine, based on these discussions and weekly monitoring, that Freddie Mac had unreasonably deviated from the framework established by OFHEO, OFHEO would require the company to submit a remedial plan or to take other remedial steps.

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

OFHEO indicated that this framework is temporary and will be lifted when the Director of OFHEO determines that it should expire based on Freddie Mac's resumption of timely financial reporting that complies with GAAP and certain other factors.

Management believes that this framework will provide OFHEO with a mechanism to ensure that the company manages its business with continued prudence and appropriate levels of capital, taking into account that the company is not currently able to produce timely financial statements.

NOTE 11: STOCK-BASED COMPENSATION

Freddie Mac has three stock-based compensation plans under which grants are being made: the Employee Stock Purchase Plan ("ESPP"), the 1995 Stock Compensation Plan ("1995 Employee Plan") and the 1995 Directors' Stock Compensation Plan, as amended and restated in 1998 ("Directors' Plan").

Common stock delivered under these plans may be shares currently held by Freddie Mac as treasury stock, shares purchased by Freddie Mac in the open market or newly issued shares.

ESPP: Freddie Mac has established a stockholder-approved ESPP that is qualified under Internal Revenue Code ("IRC") Section 423. Under the ESPP, substantially all full-time and part-time employees may purchase shares of common stock. During 2003, 2002 and 2001, the maximum market value of stock available for annual purchase is $20,000 per employee as determined on the subscription date. For grants made through 2003, the purchase price is equal to 85 percent of the average price of the stock on the subscription (grant) date or the purchase (exercise) date, whichever is lower.

Table 11.1 provides a summary of activity related to the ESPP.

Table 11.1 — Summary of ESPP Activity

	Year Ended December 31,		
	2003	2002	2001
Shares pledged[1]	145,866	1,000,370	799,654
Fair value on grant date[2]	$ 10.72	$ 13.53	$ 18.15
Shares purchased[1]	355,485	351,629	914,167
Purchase price[3]	$ 41.76	$ 51.74	$ 33.20

(1) In 2003, employees pledged to purchase shares on August 1 and November 1 with the purchase occurring on October 31, 2003 and January 31, 2004, respectively. During 2002 and 2001, employees pledged to purchase shares on August 1 of each year with the purchase occurring on July 31 of the following year.
(2) The 2003 amount is the weighted average of the fair value on two separate grant dates. The 2002 and 2001 amounts are the actual fair values on a single grant date.
(3) The 2003 amount is the weighted average of the purchase prices on two separate purchase dates. The 2002 and 2001 amounts are the actual purchase prices on a single purchase date.

The maximum number of shares of common stock that may be granted to employees under the ESPP is 12 million shares. At December 31, 2003, approximately 8.5 million shares had been issued under the ESPP and approximately 3.5 million shares remained available for grant. Grants under the ESPP will cease upon the earlier of exhausting the authorized share pool, the effective date of the approval of the 2004 ESPP by stockholders at the 2004 annual meeting, or December 31, 2004.

1995 Employee Plan: Under the stockholder-approved 1995 Employee Plan, Freddie Mac is permitted to grant to employees stock-based awards, including stock options with dividend rights, restricted stock units ("RSUs") with dividend rights, restricted stock and stock appreciation rights ("SARs"). Such awards are generally forfeitable for at least one year after the date of grant, and Freddie Mac has the right to impose performance conditions with respect to any awards under the 1995 Employee Plan. To date, no SARs have been granted under the 1995 Employee Plan.

- Stock options granted under the 1995 Employee Plan allow for the purchase of Freddie Mac's common stock at an exercise price equal to the fair value of the common stock on the grant date. Options generally may be exercised for a period of 10 years from the grant date, subject to a vesting schedule commencing on the grant date. Dividend rights provide participants with the right to receive, at the time stock options are exercised or upon expiration, an amount equal to the accumulated dividends paid on the stock from the date the options were granted.

- Each RSU entitles the participant to receive one share of common stock at a specified future date. RSUs do not have voting rights, but do have dividend rights, which are paid to the RSU holder as dividends on common stock are declared.

- 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 by Freddie Mac.

The maximum number of shares of common stock that may be granted to employees under the 1995 Employee Plan is 33.6 million shares. At December 31, 2003, a total of approximately 29.2 million shares had been issued and approximately 4.4 million shares remained available for grant. Grants under the 1995 Employee Plan will cease upon the earliest of exhausting the authorized share pool, the effective date of the approval of the 2004 Stock Compensation Plan by stockholders at the 2004 annual stockholders' meeting, or December 31, 2004.

Directors' Plan: Under the stockholder-approved Directors' Plan, Freddie Mac is permitted to grant stock options with dividend rights, restricted stock and RSUs with dividend rights to non-employee members of the Board of Directors ("Directors"). The accounting for stock options with dividend rights, restricted stock, and RSUs granted under the Directors' Plan is identical to that of the 1995 Employee Plan.

Under the Directors' Plan, on the date of the annual meeting, each reelected or reappointed Director is granted an option to purchase shares of Freddie Mac's common stock with a market value of approximately $150,000 on the date of the grant. Each such Director also receives restricted stock units relating to common stock with a market value of approximately $65,000 on the date of the award. On the date of the annual meeting (or, for new Directors elected by the Board or appointed by the President between annual meetings, the first meeting attended after their election or appointment), newly elected and newly appointed Directors receive an option to purchase shares with a market value of approximately $300,000 and restricted stock units relating to common stock with a market value on the date of grant of approximately $130,000. Those Directors are not eligible to receive any additional grants in their second term. The exercise price of an option is equal to the market value of a share of the company's common stock on the date of the grant. The number of restricted stock units and shares subject to a stock option are calculated by dividing the dollar amount of the award by the market value of Freddie Mac's common stock on the date of grant. Vesting with respect to both stock options and restricted stock units occurs in even increments over five terms on the Board, with 20 percent vesting at the end of every term of office, unless vesting is accelerated under certain circumstances including death, disability or retirement from the Board.

For Directors, stock options and restricted stock units have dividend rights that entitle the grantee to dividend equivalents on each share subject to the grant in the amount of dividends per share payable on Freddie Mac's outstanding shares of common stock. Dividend equivalents on stock options are accrued and are payable in cash upon exercise or expiration of the option. Dividend equivalents on restricted stock units are accrued as additional restricted stock units to be settled at the same time as the underlying restricted stock units and are not subject to a vesting schedule.

The maximum number of shares of common stock that may be granted to Directors under the Directors' Plan is 2.4 million shares. At December 31, 2003, a total of approximately 0.7 million shares had been issued and approximately 1.7 million shares remained available for grant. Grants under the Directors' Plan will cease upon the earlier of exhausting the authorized share pool or Freddie Mac's Annual Meeting of Stockholders in 2008.

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

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

	Year Ended December 31,					
	2003		2002		2001	
	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price
Outstanding, beginning of year	9,231,105	$44.21	8,721,962	$37.56	9,035,859	$29.23
Granted	1,216,442	53.28	1,686,285	64.12	1,444,846	67.18
Exercised	(1,052,156)	23.12	(997,127)	18.44	(1,588,118)	16.18
Forfeited or expired	(739,051)	57.18	(180,015)	51.52	(170,625)	46.31
Outstanding, end of year	8,656,340	$46.89	9,231,105	$44.21	8,721,962	$37.56
Options exercisable at year-end	4,755,640	$38.23	4,508,095	$29.60	4,532,265	$23.29
Weighted-average fair value of options granted during year		$21.84		$28.13		$30.29

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

Table 11.3 — Employee Plan and Directors' Plan Restricted Stock and RSU Activity

	Year Ended December 31,					
	2003		2002		2001	
	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units
Outstanding, beginning of year	1,089,327	359,227	1,478,779	51,632	1,563,943	48,871
Granted[1]	—	1,146,164	—	325,902	367,902	28,289
Lapse of restrictions	(381,103)	(114,240)	(383,199)	(10,457)	(433,023)	(18,556)
Forfeited	(141,589)	(95,429)	(6,253)	(7,850)	(20,043)	(6,972)
Outstanding, end of year	566,635	1,295,722	1,089,327	359,227	1,478,779	51,632
Weighted-average fair value of awards granted during year	N/A	$ 55.01	N/A	$ 64.22	$ 67.06	$ 65.02

(1) Prior to 2002, RSUs were granted under the Directors' Plan only. During 2003, 1,143,810 RSUs were granted under the Employee Plan and 2,354 RSUs were granted under the Directors' Plan. During 2002, 313,740 RSUs were granted under the Employee Plan and 12,162 RSUs were granted under the Directors' Plan.

The increase in the volume of forfeitures of stock options (shown in Table 11.2), restricted stock and RSUs (shown in Table 11.3) during 2003 is primarily attributable to the departure of certain executives.

Table 11.4 provides additional information for stock options outstanding under the Employee Plan and the Directors' Plan at December 31, 2003 by range of exercise prices.

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

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Outstanding at December 31, 2003	Weighted Average Remaining Contract Life in Years	Weighted Average Exercise Price	Exercisable at December 31, 2003	Weighted Average Exercise Price
$9.00 to 14.99	101,234	0.7	$14.21	101,234	$14.21
15.00 to 24.99	1,629,904	1.6	18.40	1,629,904	18.40
25.00 to 34.99	527,503	3.1	34.13	527,503	34.13
35.00 to 44.99	1,265,327	5.2	41.56	750,123	41.64
45.00 to 54.99	1,924,668	6.4	50.43	629,641	47.31
55.00 to 64.99	2,137,973	6.2	62.83	744,002	61.93
65.00 to 67.99	1,069,731	5.7	67.72	373,233	67.77
	8,656,340	4.9	$46.89	4,755,640	$38.23

Compensation Expense: Compensation expense related to stock-based compensation plans charged to Salaries and employee benefits was $65 million, $66 million and $61 million for the years ended December 31, 2003, 2002 and 2001, respectively. Amounts include approximately $1 million of expense each year related to RSU dividend rights paid in cash and pre-1995 dividend rights that are not recorded through Additional paid-in capital.

Table 11.5 summarizes the weighted-average assumptions used in determining the fair value of options granted under Freddie Mac's stock-based compensation plans.

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

	Employee Stock Purchase Plan			Employee and Directors' Stock Compensation Plans		
	2003	2002	2001	2003	2002	2001
Dividend yield[1]	2.01%	1.56%	1.21%	—	—	—
Expected life	3 months	1 year	1 year	7 years	7 years	7 years
Expected volatility	35.0%	21.0%	32.0%	32.0%	32.0%	32.0%
Risk-free interest rate	0.95%	1.75%	3.57%	3.40%	4.75%	5.00%

(1) The dividend yield assumption is zero percent for the Employee Plan and Directors' Plan since options granted under these plans include dividend rights.

NOTE 12: DERIVATIVES

Freddie Mac principally uses the following types of derivatives:

- **LIBOR-Based Interest-Rate Swaps:** Interest-rate swaps are contractual agreements between two parties for the exchange of periodic payments based on a pre-determined amount ("notional") and agreed-upon fixed and floating interest rates.
- **LIBOR and Treasury-Based, Exchange-Traded Futures Contracts:** Futures contracts are exchange-traded agreements that obligate one party to sell and another party to purchase a specified amount of a designated financial instrument at a specified price and date.
- **LIBOR and Treasury-Based Options and Swaptions:** Options are exchange-traded or over-the-counter agreements that give the holder the right, but not the obligation, to buy or sell a specified asset or enter into a contract at a specified price during a specified period of time. Option holders will generally exercise their options only if there is an economic advantage in doing so. Swaptions are options to execute an interest-rate swap at a specific date and specific rates.
- **LIBOR and Treasury-Based Interest-Rate Caps and Floors:** Interest-rate caps and floors are agreements in which the holder pays a one-time up-front premium to another party in exchange for the right to receive interest payments based on a particular notional amount and the amount, if any, by which the agreed-upon index rate exceeds a specified maximum ("cap") or by which the agreed-upon index is below a specified minimum ("floor") rate.
- **Foreign-Currency Swaps:** Currency swaps are contractual agreements between two parties for the exchange of a specified amount of a designated foreign currency for a specified amount of U.S. dollars at the inception and termination of the contract. Each party will also make periodic interest payments on the currency it receives in the swap at agreed-upon fixed or floating interest rates.
- **Forward Purchase and Sale Commitments:** Forward purchase and sale commitments are over-the-counter agreements that obligate one party to purchase (sell) and another party to sell (purchase) a specified amount of a designated financial instrument at a specified price and date.
- **Other:** Certain other agreements entered into are accounted for as derivatives in accordance with SFAS 133. This includes a prepayment management agreement, in which Freddie Mac is partially compensated for the adverse impacts caused by disproportionately higher mortgage prepayments on certain mortgage pools. This also includes credit risk-sharing agreements, where Freddie Mac remits or receives payments based upon the default performance of certain mortgage loans.

Hedging Activity

No hedge designation

A significant portion of the company's derivative portfolio is not designated in hedge accounting relationships. These derivatives are reported at their fair value as either Derivative assets, at fair value or Derivative liabilities, at fair value on the consolidated balance sheets with changes in fair value reported in Derivative gains (losses) on the consolidated statements of income. For interest-rate swaps that are not designated in hedge accounting relationships, the associated interest received or paid is recognized on an accrual basis and recorded in Derivatives gains (losses) on the consolidated statements of income. For purchase and sale commitments of securities classified as trading under SFAS 115, fair value gains and losses are reported as Gains (losses) on investment activity on the consolidated statements of income.

Fair-value hedges

Fair-value hedges represent hedges of exposure to changes in the fair value of a recognized fixed-rate asset, liability or firm commitment. Freddie Mac uses interest-rate swaps, futures, and forward contracts to hedge against the changes in fair value of fixed rate debt due to changes in benchmark interest rates, either the rate on U.S. Treasury obligations or LIBOR, or foreign currency fluctuations, or a combination of both. These derivatives are often executed to manage interest-rate risk at an aggregate portfolio level. However, for

accounting purposes, Freddie Mac links its fair-value hedges to specific debt positions. Therefore, to maintain highly effective accounting hedges in this strategy, Freddie Mac frequently resets the amount of fixed-rate debt being hedged. To accomplish this, the accounting hedges are typically terminated at the time of the reset and the derivatives are contemporaneously redesignated in new hedge accounting relationships of fixed-rate debt. For 2003, no amounts have been excluded from the assessment of effectiveness for derivatives designated as fair-value hedges. For 2002 and 2001, losses of $103 million and $7 million, respectively were excluded from the assessment of effectiveness for derivatives designated as fair-value hedges. The excluded component represents the change in fair-value related to the difference between the spot price and the forward price on certain sale commitments used as hedges of existing mortgage-related securities.

Derivatives designated as fair-value hedges are reported at their fair-value as either Derivative assets, at fair-value or Derivative liabilities, at fair-value on the consolidated balance sheets. For a derivative qualifying as a fair-value hedge, Freddie Mac reports changes in the fair-value of the derivative as Hedge accounting gains (losses) on the consolidated statements of income along with the changes in the fair-value of the hedged item attributable to the risk being hedged. Hedge ineffectiveness arises when the fair-value change of a derivative is not equal to the fair-value change of the hedged item. For 2003, 2002 and 2001, hedge ineffectiveness related to fair-value hedges was a net $697 million gain, $241 million gain and $280 million loss, respectively, and was reported in Hedge accounting gains (losses). Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge accounting relationships and the extent to which differences in the characteristics or terms of the derivative and the hedged item result in fair-value changes that are not exactly offset. For example, a significant portion of derivatives in our fair-value hedges are forward starting and valued using forward rates while the hedged debt is valued using spot rates. Therefore, the difference between the spot rate and the forward rate generally produces ineffectiveness in these fair-value hedges.

Cash-flow hedges

Cash-flow hedges represent hedges of exposure to the variability in the cash flows of a recognized floating-rate asset or liability or a forecasted transaction. Freddie Mac uses interest-rate swaps, futures, foreign-currency swaps and forward contracts to hedge the changes in cash flows associated with the forecasted issuances of debt, forecasted purchase or sale of mortgage-related assets, and foreign currency fluctuations.

Derivatives designated as cash-flow hedges are reported at their fair-value as either Derivative assets, at fair-value or Derivative liabilities, at fair-value with changes in fair-value generally reported in AOCI, net of taxes, on the consolidated balance sheets to the extent the hedge is effective. The remaining ineffective portion, calculated using the hypothetical derivative method, is reported as Hedge accounting gains (losses) on the consolidated statements of income. This method requires the company to develop a hypothetical derivative whose terms match those of the hedged item and compare estimated changes in it to changes in the hedging derivative. For 2003, 2002 and 2001, hedge ineffectiveness related to cash-flow hedges was a net $53 million loss, $54 million loss and $14 million loss, respectively. No amounts have been excluded from the assessment of effectiveness for derivatives designated as cash-flow hedges for 2003, 2002 and 2001.

The maximum length of time over which Freddie Mac hedges the exposure related to the variability in future cash flows on forecasted debt issuances is thirty years. However, over 90 percent of the AOCI, net of taxes, balance at December 31, 2003 relating to cash flow hedges, is attributable to cash flow hedges of the exposure related to the variability in future cash flows on forecasted debt issuances of 15 years or less.

Under SFAS 133, AOCI amounts are reclassified to earnings as the associated hedged forecasted issuance of debt and forecasted mortgage purchase transaction affects earnings. During 2003, 2002 and 2001, pre-tax amounts reclassified into earnings also include net gains of $29 million, $116 million and $46 million, respectively, resulting from the determination that it was probable that forecasted transactions related to certain mortgage purchases and sales would not occur. As of December 31, 2003, the total AOCI, net of taxes, related to cash-flow hedge relationships was a loss of $7.8 billion on an after-tax basis. The $7.8 billion in hedging losses related to cash-flow hedges was composed of approximately $1.9 billion in net unrealized derivatives losses on open hedges and approximately $5.9 billion in deferred derivatives net losses on closed

hedges. The $1.9 billion in unrealized fair-value losses on existing cash-flow hedges can change substantially due to future changes in interest rates. 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. Assuming no changes in interest rates or other factors affecting derivative valuations, the company estimates that approximately $2.5 billion (net of taxes) of the $7.8 billion of hedging losses (of which $5.9 billion are deferred losses and $1.9 billion are unrealized losses) in AOCI, net of taxes, at December 31, 2003 will be reclassified into earnings during 2004.

Table 12.1 presents the changes in AOCI, net of taxes, related to derivatives designated as cash-flow hedges. The Cumulative effect of change in accounting principle, net of tax benefit line represents the cumulative change in fair value, after the effects of Freddie Mac's statutory tax rate of 35 percent, on all derivatives that were designated as cash-flow hedges on January 1, 2001, the date Freddie Mac adopted SFAS 133. The "Net change in fair value related to cash flow hedging activities, net of tax benefit" line represents the net changes in the fair value of the derivatives, that were designated as cash-flow hedges throughout the year, after the effects of Freddie Mac's statutory tax rate of 35 percent, to the extent the hedges were effective. The Net reclassifications to earnings, net of tax expense line represents the AOCI amount, after the effects of Freddie Mac's statutory tax rate of 35 percent, that was recognized in earnings as the originally hedged forecasted transactions affected earnings unless it was deemed probable that the forecasted transaction would not occur. If it is probable that the forecasted transaction will not occur, then the entire deferred gain or loss associated with the hedge related to the forecasted transaction is reclassified into earnings immediately.

Table 12.1 — AOCI, net of taxes, Related to Cash-Flow Hedge Relationships

	Year Ended December 31,		
	2003	**2002**	**2001**
	(dollars in millions)		
Beginning Balance[1]	$(9,877)	$(4,757)	$ —
Cumulative effect of change in accounting principle, net of tax benefit of $1,422 for the year ended December 31, 2001	—	—	(2,640)
Net change in fair value related to cash flow hedging activities, net of tax benefit of $(352), $(4,516) and $(1,763) for the years ended December 31, 2003, 2002 and 2001, respectively[2]	(653)	(8,388)	(3,276)
Net reclassifications to earnings, net of tax expense of $1,450, $1,760 and $624 for the years ended December 31, 2003, 2002 and 2001, respectively[2]	2,693	3,268	1,159
Ending Balance[1]	$(7,837)	$(9,877)	$(4,757)

(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 reclassifications to earnings, net of tax expense includes the accrual of periodic cash settlements in accordance with the contractual terms of the derivative designated in a cash flow hedge relationship for all periods presented above. For 2002 and 2001, such accruals were previously reported in Net change in fair value related to cash-flow hedging activities, net of tax benefit, and totaled $2,247 million and $1,058 million, respectively, on an after-tax basis.

NOTE 13: LEGAL CONTINGENCIES

Freddie Mac is 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 the company's business. Freddie Mac is frequently involved, directly or indirectly, in litigation involving mortgage foreclosures. Freddie Mac is also involved in proceedings arising from its termination of a seller/servicer's eligibility to sell mortgages to, and service mortgages for, the company. In these cases, the former seller/servicer sometimes seeks damages against Freddie Mac for wrongful termination under a variety of legal theories. In addition, Freddie Mac is sometimes sued in connection with the origination or servicing of mortgages. These suits generally involve claims alleging wrongful actions of seller/servicers. Freddie Mac's contracts with its seller/servicers generally provide for them to indemnify the company against liability arising from their wrongful actions.

Freddie Mac is now subject to various legal proceedings, including regulatory investigations and administrative and civil litigation, arising from the restatement of its previously issued consolidated financial statements for the years 2000 and 2001 and the first three quarters of 2002 and the revision of fourth quarter and full-year consolidated financial statements for 2002 (collectively referred to as the "restatement"). Freddie Mac believes that a loss in connection with the proceedings arising from the restatement is probable and currently estimates the range of minimum loss to be from $75 million to $100 million. Freddie Mac has established a reserve of $75 million for this loss contingency in the second quarter of 2003, the period in which many of the legal proceedings were initiated. The ultimate resolution of these proceedings could result in losses lower than or in excess of the estimated range of minimum loss. Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. It is not possible for the company to reasonably estimate the upper end of the range of any additional losses that might result from the adverse resolution of any of these legal proceedings, or their potential effect on the company's financial condition or results of operations.

Securities Class Action Lawsuits. In June 2003 and thereafter, securities class action lawsuits were brought in three separate federal district courts against Freddie Mac and certain former executive officers in connection with the restatement. While most of the cases were voluntarily dismissed by the plaintiffs, the two remaining ones were consolidated and are now pending in the U.S. District Court for the Southern District of New York.

In essence, the plaintiffs in the consolidated action claim that the defendants improperly managed earnings to create a misleading impression of steady earnings by Freddie Mac. Plaintiffs further allege that defendants engaged in a number of improper transactions that violated GAAP and that they made false and misleading statements regarding Freddie Mac's financial status. The complaint, which covers the period from June 15, 1999 through June 6, 2003, seeks unspecified compensatory damages, costs and expenses.

In March 2004, the plaintiffs in one of the cases, the Ohio Public Employees Retirement System and the State Teachers Retirement System, were appointed lead plaintiffs for the consolidated action. Freddie Mac filed a motion to dismiss the action in April, which was denied by the court on July 19, 2004. The case is now in the discovery phase.

Shareholder Derivative Lawsuits. Two shareholder derivative lawsuits were filed during 2003 against Freddie Mac and certain former and current executives and members of Freddie Mac's Board of Directors alleging breach of fiduciary duty in connection with the restatement. Both cases were ultimately assigned to the same judge in New York who is handling the securities class action lawsuits described above. In July 2003, all of the then current Board members were dismissed from the lawsuits in which they were named with the consent of the plaintiff. On January 16, 2004, Freddie Mac moved to dismiss one of the lawsuits because of the plaintiff's failure to make a pre-suit demand. The court dismissed the case without prejudice on July 19, 2004. That plaintiff has since sent a demand notice to Freddie Mac. The other lawsuit is still pending, awaiting Freddie Mac's Board of Directors' response to the plaintiff's pre-suit demand notice.

ERISA Lawsuits. Two class action lawsuits were filed in 2003 in the U.S. District Court for the Southern District of Ohio against Freddie Mac, certain individuals, and the company's Retirement Committee alleging violations of the Employee Retirement Income Security Act ("ERISA"). Both actions were consolidated and transferred to the same judge in New York who is handling the securities and derivative

lawsuits described above. In July 2004, Freddie Mac and the other defendants filed a motion to dismiss the consolidated ERISA lawsuit. That motion is pending.

OFHEO Investigation. In June 2003, OFHEO commenced a special investigation of the company in connection with the restatement. As part of this investigation, OFHEO took the testimony of certain Freddie Mac employees and directors, external third parties and former employees. OFHEO also requested and received documents from the company.

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

In December 2003, OFHEO filed administrative notices of charges against Freddie Mac and Messrs. Brendsel and Clarke, two former executive officers of Freddie Mac. In its charge against Freddie Mac, OFHEO seeks to have Freddie Mac take certain actions in connection with these individuals' salaries and compensation as well as their termination status with the company. Freddie Mac and Messrs. Brendsel and Clarke moved, among other things, to dismiss the OFHEO administrative charges. These motions are pending.

On August 31, 2004, in a separate action, the U.S. District Court for the District of Columbia issued an order finding that OFHEO lacked the authority to freeze the compensation and benefits provided under Mr. Brendsel's employment agreement. Freddie Mac was not a party to this action. An appeal could be taken from this order. The administrative proceedings concern, among other things, OFHEO's demand to change Mr. Brendsel's termination status and its request for penalties against him are still pending.

SEC Investigation. In June 2003, the SEC initiated a formal investigation of Freddie Mac in connection with the restatement. As part of the investigation, the SEC subpoenaed company documents and took the sworn testimony of various present and former Freddie Mac employees and directors, as well as third parties.

On August 18, 2004, Freddie Mac announced that it had received a "Wells Notice" from the staff of the SEC. The Wells Notice advised the company that the SEC staff is considering recommending that the SEC initiate a civil injunctive action against the company for possible violations of federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934 and the SEC's Rule 10b-5, as well as Sections 17(a)(1), (2) and (3) of the Securities Act of 1933. The Wells Notice also indicated that the SEC staff may seek a permanent injunction and a civil money penalty in connection with the contemplated action. Freddie Mac continues to cooperate fully with the SEC's investigation as the company evaluates its response to the Wells Notice.

U.S. Attorney's Investigation. In June 2003, the U.S. Attorney's Office in Alexandria, Virginia commenced an investigation of Freddie Mac surrounding the restatement. As part of its investigation, the U.S. Attorney's Office requested and received documents and information from Freddie Mac, interviewed certain Freddie Mac employees and possibly other parties and took testimony before the grand jury. The investigation is still pending and Freddie Mac will continue to cooperate with the U.S. Attorney's Office.

Department of Labor Investigation. In July 2003, the Department of Labor ("DOL") began an investigation of Freddie Mac's 401(k) Plan in relation to the restatement. In connection with the investigation, the DOL sought and received documents from the company as well as interviewed certain present and former members of Freddie Mac's Retirement Committee. The investigation is still pending and Freddie Mac continues to cooperate fully with the DOL.

Other Inquiries. Freddie Mac received inquires from the Internal Revenue Service ("IRS") in connection with its regular audits of Freddie Mac's tax returns for prior years, some of which relate to matters connected with the restatement. Freddie Mac continues to respond to these inquiries. See "NOTE 14: INCOME TAXES" for more information. The Committee on Energy and Commerce of the House of Representatives also sent Freddie Mac an inquiry relating to the restatement. Freddie Mac has responded to the Committee's inquiry.

NOTE 14: INCOME TAXES

Freddie Mac is exempt from state and local income taxes. Table 14.1 presents the components of the company's Provision for income taxes.

Table 14.1 — Provision for Income Taxes

	Year Ended December 31,		
	2003	2002	2001
	(dollars in millions)		
Current tax provision	$1,465	$2,023	$1,584
Deferred tax provision	737	2,690	(245)
Total provision for income taxes	$2,202	$4,713	$1,339

Table 14.2 summarizes Freddie Mac's deferred tax asset and liability.

Table 14.2 — Deferred Tax Asset/(Liability)

	December 31,	
	2003	2002
	(dollars in millions)	
Deferred tax assets:		
Deferred fees related to securitizations	$ 1,550	$ 1,308
Basis differences related to assets held for investment	195	139
Employee compensation and benefit plans	141	136
Credit related items and reserve for loan losses	—	11
Other items, net	—	61
Cash flow hedge deferrals and unrealized (gains) losses related to available-for-sale securities	801	—
Total deferred tax assets	2,687	1,655
Deferred tax liabilities:		
Premium and discount amortization	(1,958)	(1,826)
Basis differences related to derivative instruments	(3,468)	(2,639)
Credit related items and reserve for loan losses	(2)	—
Other items, net	(5)	—
Cash flow hedge deferrals and unrealized (gains) losses related to available-for-sale securities	—	(1,260)
Total deferred tax liabilities	(5,433)	(5,725)
Net deferred tax liabilities	$(2,746)	$(4,070)

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

A valuation allowance has not been established against Freddie Mac's deferred tax assets as of December 31, 2003 or 2002, as Freddie Mac has determined that it is more likely than not that all such tax assets will be realized in the future.

Table 14.3 reconciles the statutory federal tax rate to the effective tax rate before the cumulative effects of changes in accounting principles.

Table 14.3 — Reconciliation of Statutory to Effective Tax Rate

	Year Ended December 31,		
	2003	2002	2001
Statutory corporate rate	35.0%	35.0%	35.0%
Tax-exempt interest and dividends-received deductions	(2.1)	(1.2)	(3.6)
Tax credits	(3.0)	(1.1)	(2.9)
Provision (benefit) related to tax contingencies	0.4	(1.0)	1.4
OFHEO civil money penalty and loss contingency accrual	1.0	—	—
Other	0.1	0.1	0.2
Effective rate	31.4%	31.8%	30.1%

Impact of tax issues. The IRS has a policy to examine the income tax returns of large corporate taxpayers, including Freddie Mac, generally every year. Management believes that an adequate provision in accordance with SFAS 5 has been made for contingencies related to all income taxes and related interest. However, the ultimate outcome of these tax contingencies could result in a tax benefit or tax provision that could be material to Freddie Mac's quarterly or annual results of operations. Based on current knowledge and after consultation with outside counsel, management does not believe that liabilities arising from these matters, if any, will have a material adverse effect on Freddie Mac's consolidated financial condition.

Tax Years 1985 to 1990. In 1998, the IRS issued Freddie Mac a Statutory Notice which asserts income tax deficiencies for the company's first two tax years, 1985 and 1986. In the first quarter of 1999, Freddie Mac filed a petition in the United States Tax Court (the "Court") to contest the deficiencies. In the third quarter of 1999, the IRS issued a Statutory Notice for Freddie Mac's tax years 1987 to 1990, and Freddie Mac filed a petition in the Court. Subsequently, the Court combined the 1985 to 1990 tax years into one case. The principal matters in controversy in the case involve questions of tax law as applied to Freddie Mac's transition from non-taxable to taxable status in 1985 and primarily involve the amortization of certain intangible assets, the two most significant of which are:

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

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

While significant, the Court's rulings do not dispose of all of the matters in controversy in the case, which, upon final resolution by the Court of all such matters, are subject to appeal by the parties. In addition, Freddie Mac still must demonstrate that the intangible assets in question have an ascertainable value and have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

In view of the favorable rulings described above and in accordance with GAAP, Freddie Mac recorded in the fourth quarter of 2002 a reduction in its tax reserves in the amount of $155 million. If the IRS were to

appeal the Court decisions and an adverse ruling resulted, Freddie Mac may reconsider its reserves related to this matter.

If Freddie Mac's tax position on the customer relationship amortization issue described above is upheld through the administrative and legal process, Freddie Mac will be able to recognize additional tax benefits that could be material in the quarter during which they are recognized. However, Freddie Mac is unable to provide assurances that any such tax benefits will be realized.

Tax Years 1991 to 1993. The IRS examination of Freddie Mac's federal income tax returns for the years 1991 through 1993 has been completed. In December 2001, the IRS issued a Statutory Notice for these years. In the first quarter of 2002, Freddie Mac filed a petition in the Court to contest the deficiencies. The principal matters in controversy in this case are the same questions at issue in the 1985 to 1990 case as applied to years 1991 to 1993, plus an additional question of tax law regarding the timing of taxation of Freddie Mac's management and guarantee fee income.

Tax Years 1994 to 1997. In the second quarter of 2002, the IRS completed its examination of Freddie Mac's federal income tax returns for the years 1994 through 1997. Freddie Mac is involved in discussions with the IRS Appeals Division regarding the company's disagreement with certain aspects of the examination report. The principal matters in controversy, other than the same questions at issue in the 1985 to 1993 cases, involve the character of losses on dispositions of mortgage securities and certain issues relating to Freddie Mac's REIT subsidiaries.

Tax Treatment of REITs. In February 1997, Freddie Mac formed two REIT subsidiaries that issued a total of $4 billion in step-down preferred stock to investors. Under the IRS regulations in effect when the REITs were formed, the company believed that the dividend payments by the REITs to holders of the REITs' step-down preferred stock were fully tax deductible. In 1997, subsequent to the formation of Freddie Mac's REIT subsidiaries, the Department of the Treasury announced its intention to propose regulations that would effectively eliminate the potential tax advantages of REITs that issued step-down preferred stock. On January 7, 2000, the Treasury issued final regulations that retroactively deny certain tax benefits attributable to Freddie Mac's REIT preferred stock for tax years ending on or after February 27, 1997. Based upon this guidance, the IRS challenged Freddie Mac's position that the REIT dividends are fully deductible. The company has since changed its position that the REIT dividends are fully deductible. Freddie Mac has not recorded a tax benefit in its consolidated financial statements for the portion of the REIT dividends that was challenged by the IRS.

The preferred stock is redeemable by the REITs under certain circumstances described in the preferred stock offering documents as a "tax event redemption." Additionally, after an initial period ending December 31, 2006, the REITs may be able to retire the preferred stock under favorable financing terms in accordance with the terms of the preferred stock. The REITs have decided not to redeem the preferred stock at this time; however, if market conditions were viewed to be favorable in the future, the REITs may decide to redeem the preferred stock at that time.

Tax Years 1998 to 2002. The IRS is currently examining Freddie Mac's tax returns for the years 1998 through 2002. This examination includes the years for which Freddie Mac has restated its financial reporting.

Tax Treatment of Linked Swaps. In August and September of 2001, Freddie Mac entered into a series of nine sets of paired trade transactions known as "Linked Swaps." Freddie Mac has reported and paid tax treating each pair of Linked Swaps as a single integrated transaction for federal income tax purposes. There is a risk, however, that the IRS could challenge Freddie Mac's tax treatment of the Linked Swaps and make an adverse determination relating to this tax treatment. If this should occur, the potential aggregate additional tax liability could be as much as approximately $750 million plus interest.

In addition, two additional swaps were executed in November 2001. Although the facts and circumstances surrounding these swaps were different from the Linked Swaps, Freddie Mac also reported and paid tax treating these swaps as a single integrated transaction for federal income tax purposes. Management believes there are no significant tax exposures related to these swaps.

Freddie Mac has not provided reserves for any tax issues related to these transactions because management has determined that the potential for loss does not meet the criteria for recognition under SFAS 5. The IRS is currently examining Freddie Mac's 2001 and 2002 tax returns, and has yet to propose any adjustments related to these transactions. If the IRS were to propose the maximum potential aggregate assessment and that additional tax liability was upheld through the administrative and legal process, the recognition of such additional liability could have a material adverse impact on Freddie Mac's results of operations in the quarter in which it was recognized. Based on current knowledge and after consultation with counsel, management does not currently believe that the final resolution of any issues that may arise from the Linked Swaps transactions will result in IRS adjustments that would have a material adverse impact on Freddie Mac's consolidated financial condition.

NOTE 15: EMPLOYEE BENEFITS

Defined Benefit Plans

Freddie Mac maintains a tax-qualified defined benefit pension plan ("Pension Plan") covering substantially all of its employees. Pension Plan benefits are based on years of service and the employee's highest average compensation (up to legal plan limits) over any consecutive 36 months of employment. Freddie Mac's general practice is to contribute to the Pension Plan an amount equal to at least the minimum required contribution but no more than the maximum amount deductible for federal income tax purposes each year. In 2004, Freddie Mac expects to contribute approximately $12 million to its Pension Plan. Pension Plan assets are held in trust and investments consist primarily of listed stocks and corporate bonds. In addition to the Pension Plan, Freddie Mac maintains nonqualified, unfunded defined benefit pension plans for officers and certain other employees of the company. The related retirement benefits for the nonqualified plans are paid from Freddie Mac's general assets. These nonqualified and qualified defined benefit pension plans are collectively referred to in this NOTE 15 as "defined benefit pension plans."

Freddie Mac maintains a defined benefit post-retirement health care plan that provides post-retirement health care benefits on a contributory basis to retired employees age 55 or older who rendered at least ten years of service (five years of service prior to 2002) after age 35 and who, upon separation or termination, immediately elected to commence benefits under the Pension Plan in the form of an annuity. The company's post-retirement health care plan is currently unfunded and the benefits are paid from Freddie Mac's general assets. This plan, along with the defined benefit pension plans, are collectively referred to in this NOTE 15 as "defined benefit plans."

The company is required to accrue the estimated cost of retiree benefits as employees render the services necessary to earn their post-retirement benefits. Freddie Mac's pension and post-retirement health care costs related to these defined benefit plans for 2003, 2002 and 2001 presented in the following tables were calculated using assumptions as of September 30, 2002, 2001 and 2000, respectively. The funded status of Freddie Mac's pension and post-retirement health care defined benefit plans for 2003, 2002 and 2001 presented in the following tables were calculated using assumptions as of September 30, 2003, 2002 and 2001, respectively.

For financial reporting purposes, Freddie Mac uses a September 30th valuation measurement date for all of its defined benefit plans.

Table 15.1 sets forth the changes in the benefit obligation, funded status and the amounts reported in the consolidated balance sheets for the defined benefit plans at December 31, 2003 and 2002.

Table 15.1 — Defined Benefit Plan Obligations and Funded Status

	Pension Benefits[1]		Post-Retirement Benefits	
	2003	2002	2003	2002
	(dollars in millions)			
CHANGE IN BENEFIT OBLIGATION				
Benefit obligation at beginning of year	$ 230	$179	$ 54	$ 28
Amendment	—	1	—	(8)
Service cost	16	12	6	4
Interest cost	16	14	3	3
Net actuarial loss	80	27	39	27
Benefits paid	(3)	(3)	—	—
Benefit obligation at end of year	339	230	102	54
CHANGE IN PLAN ASSETS				
Fair value of plan assets at beginning of year	160	139		
Actual return (loss) on plan assets	26	(13)		
Employer contributions	46	37		
Benefits paid	(3)	(3)		
Fair value of plan assets at end of year	229	160		
FUNDED STATUS				
Funded status at end of year	(110)	(70)	(102)	(54)
Unrecognized net actuarial loss	120	57	60	23
Unrecognized prior service cost	2	2	(6)	(7)
Initial unrecognized net transition asset	1	1	—	—
Net amount recognized	$ 13	$(10)	$ (48)	$(38)
AMOUNTS RECOGNIZED IN THE CONSOLIDATED BALANCE SHEETS				
Other assets:				
Prepaid benefit cost	$ 29	$ 2	$ —	$ —
Intangible asset	1	—	—	—
Other liabilities:				
Accrued benefit liability	(27)	(12)	(48)	(38)
AOCI				
Minimum pension liability	10	—	—	—
Net amount recognized	$ 13	$(10)	$ (48)	$(38)

(1) The benefit obligations refer to projected benefit obligations.

The Amendment change for 2002 referred to in Table 15.1 for Pension Benefits relates to a 2001 Pension Plan amendment to conform to a legislative change to increase the maximum annual defined benefit limit as defined by IRC Section 415(b) and the maximum compensation limit as defined by IRC Section 401(a)(17). The Amendment change for 2002 referred to in Table 15.1 for Post-Retirement Benefits includes changes in eligibility, Medicare coordination and the level of the employer-provided subsidy for retiree medical benefits.

The accumulated benefit obligation for all defined benefit pension plans was $248 million and $170 million at December 31, 2003 and 2002, respectively.

Table 15.2 provides additional information on plans with benefit obligations in excess of plan assets, which are due to the unfunded defined benefit plans for officers and certain other employees of the company.

Table 15.2 — Information for Pension Plans with an Accumulated Benefit Obligation in Excess of Plan Assets

	December 31,	
	2003	2002
	(dollars in millions)	
Projected benefit obligation	$38	$21
Accumulated benefit obligation	27	15
Fair value of plan assets	—	—

The increase in the minimum pension liability included in AOCI, net of taxes, was $10 million and $-0- at December 31, 2003 and 2002, respectively.

Table 15.3 presents the components of the net periodic benefit costs with respect to pensions and other post-retirement benefits for the years ended December 31, 2003, 2002 and 2001. Net periodic benefit costs are included in the line Salaries and employee benefits on the company's consolidated statements of income.

Table 15.3 — Net Periodic Benefit Cost Detail

	Pension Benefits			Post-Retirement Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2003	2002	2001	2003	2002	2001
	(dollars in millions)					
Service cost of current period	$16	$12	$12	$ 6	$4	$ 2
Interest cost on benefit obligation	16	14	12	3	3	2
Expected return on plan assets	(12)	(13)	(13)	—	—	—
Recognized net actuarial (gain) loss	3	—	(1)	2	1	—
Recognized prior service cost	—	—	—	(1)	(1)	—
Net periodic benefit costs	$23	$13	$10	$10	$7	$ 4

Tables 15.4 and 15.5 summarize the weighted average assumptions used to determine benefit obligations at December 31, 2003 and 2002 and net periodic benefit costs for the years ended December 31, 2003, 2002 and 2001, respectively.

Table 15.4 — Weighted Average Assumptions Used to Determine Projected and Accumulated Benefit Obligations

	Pension Benefits		Post-Retirement Benefits	
	December 31,		December 31,	
	2003	2002	2003	2002
MAJOR ASSUMPTIONS:				
Discount rate	6.0%	7.0%	6.0%	7.0%
Rate of future compensation increase	4.5%	4.5%	—	—

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

	Pension Benefits			Post-Retirement Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2003	2002	2001	2003	2002	2001
MAJOR ASSUMPTIONS:						
Discount rate	7.00%	7.50%	7.75%	7.00%	7.50%	7.75%
Rate of future compensation increase	4.50%	4.50%	4.50%	—	—	—
Expected long-term rate of return on plan assets	7.25%	9.00%	9.00%	—	—	—

During 2003, management enhanced the methodologies underlying the assumptions in Table 15.4 and Table 15.5 above. For 2003 year-end benefit obligations, Freddie Mac used the Moody's Aa Corporate Bond Rate as a basis for selecting the discount rate shown in Table 15.4. Previously, a hypothetical bond model portfolio was used. To estimate the return on plan assets for 2003, Freddie Mac used a portfolio return calculator model, which considers the historical returns and the future expectations for returns for each asset class. Previously that assumption was estimated after consideration of historical returns, the current economic environment and surveys of expected long-term investment return rates for other financial institutions. These changes did not result in a material effect on financial position or results of operations.

The assumed health care cost trend rates used in measuring the accumulated post-retirement benefit obligation are 13 percent in 2004, gradually declining to an ultimate rate of 5 percent in 2009 and remaining at that level thereafter.

Table 15.6 sets forth the effect on the accumulated post-retirement benefit obligation and the sum of the service-cost and interest-cost components of the net periodic post-retirement benefit costs that would result from a 1 percent increase or decrease in the assumed health care cost trend rate.

Table 15.6 — Selected Data Regarding Post-Retirement Plans

	One Percent Increase	One Percent Decrease
	(dollars in millions)	
Effect on the accumulated post-retirement benefit obligation for health care benefits	$24	$(19)
Effect on the net periodic post-retirement benefit cost components	2	(2)

Plan Assets

Table 15.7 sets forth Freddie Mac's pension plan weighted average asset allocations, based on fair value, at December 31, 2003 and 2002, and target allocation by asset category.

Table 15.7 — Pension Plan Assets by Category

Asset Category	Target Allocation 2002 - 2003	Plan Assets at December 31 2003	Plan Assets at December 31 2002
Equity securities	65.0%	52.6%	63.6%
Debt securities	35.0%	28.2%	30.2%
Other[(1)]	—	19.2%	6.2%
Total	100.0%	100.0%	100.0%

(1) Consists of cash contributions made in the fourth quarter of 2003 and 2002 and not yet fully invested by December 31st.

Freddie Mac employs a total return investment approach whereby a diversified blend of equities and fixed income investments are 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 liabilities, plan funded status, and corporate financial condition. Furthermore, equity investments are diversified across U.S. and non-U.S. listed companies

with small and large capitalizations. Derivatives may be used to gain market exposure in an efficient and timely manner; however, derivatives may not be used to leverage the portfolio beyond the market value of the underlying investments. Investment risk is measured and monitored on an ongoing basis through quarterly investment portfolio reviews, annual liability measurements and periodic asset/liability studies.

The Pension Plan assets did not include any direct ownership of Freddie Mac securities at December 31, 2003 and 2002.

Cash Flows

Contributions

In 2004, Freddie Mac expects to contribute approximately $12 million to its defined benefit pension plans and its other post-retirement benefit plan. Any contributions to the company's other post-retirement benefit plan will be in the form of benefit payments since it is an unfunded plan.

Estimated Future Benefit Payments

Table 15.8 sets forth estimated future benefit payments expected to be paid. The expected benefits are based on the same assumptions used to measure Freddie Mac's benefit obligation at December 31, 2003.

Table 15.8 — Estimated Future Benefit Payments

	Pension Benefits	Post-Retirement Benefits
	(dollars in millions)	
2004	$3.4	$1.0
2005	4.0	1.0
2006	4.9	1.3
2007	6.3	1.7
2008	7.4	2.2
Years 2009-2013	68.9	19.2

Defined Contribution Plans

Freddie Mac also offers a tax-qualified defined contribution pension plan (the "Savings Plan") to all eligible employees. Employees were permitted to contribute from 1 percent to 15 percent of their annual salaries to the Savings Plan, up to $14,500 in 2003, 2002 and 2001 ($12,000 pre-tax and $2,500 after tax in 2003, $11,000 pre-tax and $3,500 after tax in 2002 and $10,500 pre-tax and $4,000 after tax in 2001). The company also maintains a non-qualified defined contribution plan for officers and certain other employees of the company designed to make up for benefits lost due to limitations on eligible compensation imposed by the IRC. Freddie Mac matches employees' contributions up to 6 percent of their salaries per pay period; the percentage matched depends upon the length of service. Employee contributions and Freddie Mac's matching contributions are immediately vested. In addition, Freddie Mac is authorized to make discretionary contributions to the Savings Plan on behalf of each eligible employee, based on salary level. Employees become vested in Freddie Mac's discretionary contributions after 5 years. Freddie Mac incurred costs of $28 million, $22 million and $21 million for 2003, 2002 and 2001, respectively, related to these plans. These expenses were included in Salaries and employee benefits on the consolidated statements of income.

See "NOTE 13 — LEGAL CONTINGENCIES" for more information regarding a DOL investigation of Freddie Mac's Thrift/401(k) Savings Plan in relation to the restatement.

Executive Deferred Compensation Plan

The Executive Deferred Compensation Plan is an unfunded, non-qualified plan that allows certain key employees to elect to defer a portion of their annual salary and cash bonus, and certain key management employees to defer the settlement of restricted stock units received from Freddie Mac, for any number of years specified by the employee, but under no circumstances may the period elected exceed his or her life expectancy. Deferred salary, cash bonus and stock units are credited to an employee's accounts as of the date

such amounts or units would have otherwise been paid or settled by delivery of shares to the employee. Subject to provisions for hardship withdrawals and certain terminations of employment, deferred distributions are payable at the end of the deferral period in lump sums or reasonably equal installments over five, ten or fifteen years. Distributions are paid from Freddie Mac's general assets. Freddie Mac records a liability equal to the accumulated deferred salary, cash bonus and accrued interest, net of any related distributions made to plan participants. Freddie Mac recognizes expense equal to the interest earned on deferred salary and bonus throughout the year. Expense associated with deferred restricted stock units is recognized as part of stock-based compensation.

NOTE 16: FAIR VALUE DISCLOSURES

The consolidated fair value balance sheets in Table 16.1 present Freddie Mac's estimates of the fair value of the company's recorded assets and liabilities and off-balance-sheet financial instruments as of December 31, 2003 and 2002. The consolidated fair value balance sheets include all items recorded in the consolidated balance sheets prepared in accordance with GAAP, as well as all off-balance-sheet financial instruments that represent assets or liabilities of Freddie Mac that are not recorded in the GAAP consolidated balance sheets. The valuations of financial instruments on the 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" ("SFAS 107") and other relevant pronouncements.

Table 16.1 — Consolidated Fair Value Balance Sheets[1]

	December 31,			
	2003		2002	
	Carrying Amount[2]	Fair Value[3]	Carrying Amount[2]	Fair Value
	(dollars in billions)			
Assets				
Mortgage loans	$ 60.2	$ 62.5	$ 63.9	$ 67.6
Mortgage-related securities[4][5]	600.2	600.4	525.8	526.1
Retained portfolio	660.4	662.9	589.7	593.7
Cash and cash equivalents	23.1	23.1	10.8	10.8
Investments[6]	65.4	65.4	101.2	101.2
Securities purchased under agreements to resell and Federal funds sold	20.6	20.6	23.0	23.0
Derivative assets	16.2	16.2	10.4	10.4
Guarantee asset for Participation Certificates	3.7	4.5	2.4	3.8
Other assets[5][7]	14.0	13.2	14.7	14.4
Total assets	$803.4	$805.9	$752.2	$757.3
Liabilities and minority interest				
Total debt securities, net	$739.6	$749.8	$665.7	$683.6
Guarantee obligation for Participation Certificates	2.9	2.4	1.4	2.1
Derivative liabilities	0.4	0.4	1.0	1.0
Reserve for guarantee losses on Participation Certificates	0.1	—	0.1	—
Other liabilities[7]	27.0	23.9	50.4	45.1
Minority interests in consolidated subsidiaries	1.9	2.1	2.3	2.6
Total liabilities and minority interest	771.9	778.6	720.9	734.4
Net assets attributable to stockholders				
Preferred stockholders	4.6	4.4	4.6	4.6
Common stockholders	26.9	22.9	26.7	18.3
Total net assets	31.5	27.3	31.3	22.9
Total liabilities and net assets	$803.4	$805.9	$752.2	$757.3

(1) The consolidated fair value balance sheets do not purport to present the net realizable, liquidation or market value of Freddie Mac as a whole. Furthermore, amounts Freddie Mac ultimately realized from the disposition of the assets or settlement of liabilities may vary significantly from the fair values presented.
(2) Carrying amounts equal the amounts reported on Freddie Mac's GAAP consolidated balance sheets.
(3) Methodologies employed to calculate fair values are periodically changed on a prospective basis to reflect improvements in the underlying estimation processes. The company's estimate of the overall impact of the methodology improvements implemented during 2003 is that they caused a partial offset to the increase in the fair value of net assets during the year.
(4) The fair value of mortgage-related securities reported in this table exceeds the carrying value because the fair value includes PC residuals related to Participation Certificates held in the Retained portfolio that are not recognized under GAAP.
(5) Fair value of $0.2 billion related to the credit enhancement on certain manufactured housing asset-backed securities at December 31, 2002 previously reported as Mortgage related securities has been reclassified to Other assets to conform to the current presentation.
(6) Includes mortgage-related securities held in connection with PC market-making and support activities.
(7) Fair values at December 31, 2003 and 2002 include estimated income taxes on the difference between the consolidated fair value balance sheets and the consolidated GAAP balance sheets.

Limitations

The consolidated fair value balance sheets do not capture all elements of value that are implicit in Freddie Mac's operations as a going concern since the consolidated fair value balance sheets only capture the values of the current investment and securitization portfolios. For example, the 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, the consolidated fair value balance sheets also do not capture the value associated with future growth opportunities in Freddie Mac's investment and securitization portfolios. Thus, the fair value of net assets attributable to stockholders presented in the consolidated fair value balance sheets do not represent an estimate of the net realizable, liquidation or market value of Freddie Mac as a whole.

Freddie Mac reports assets and liabilities that are not financial instruments (such as Freddie Mac's fixed assets and deferred taxes), as well as certain financial instruments that are not covered by the SFAS 107 disclosure requirements (such as pension liabilities) at their GAAP carrying amounts in the consolidated fair value balance sheets. Management believes these items do not have a significant impact on Freddie Mac's overall financial condition or fair value results.

Valuation Methods and Assumptions

The following methods and assumptions were used to estimate the fair value of assets and liabilities at December 31, 2003 and 2002.

Mortgage loans

Mortgage loans represent single-family and multifamily whole loans held in Freddie Mac's Retained portfolio. For GAAP purposes, management must determine the fair value of these mortgage loans to calculate Lower of cost or market value adjustments for mortgages classified as held for sale. Management uses this same approach when determining the fair value of all whole loans, including those held for investment, for fair value balance sheet purposes.

Freddie Mac determines the fair value of mortgage loans based on comparisons to actively traded mortgage-related securities with similar characteristics, with an adjustment for yield, credit and liquidity differences. Specifically, for fair value estimation purposes, Freddie Mac aggregates mortgage loans into pools by product type, coupon and maturity and then converts the pools into notional mortgage-related securities based on their specific characteristics. Freddie Mac then calculates fair values for these notional mortgage-related securities using the process that is described in the "Mortgage-Related Securities" section, below.

As described above, the fair value of these mortgage loans also includes an adjustment for yield, credit and liquidity differences. To accomplish this, the fair value of the single-family whole loans includes an adjustment representing the estimated present value of the additional cash flows on the mortgage coupon of the whole loan in excess of the coupon expected on the notional mortgage-related securities. For multifamily whole loans, the fair value adjustment is estimated by calculating the net present value of guarantee fees expected to be retained by Freddie Mac. 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 is also net of the related credit and other components inherent in the company's guarantee obligation. For single-family whole loans, the process for estimating the related credit and other guarantee obligation components is described in the "Guarantee Obligation for Participation Certificates" section. For multifamily whole loans, the process for estimating the related credit and other guarantee obligation components employs a market-based approach to estimate the potential credit obligation. This obligation is estimated by extracting the credit risk premium that multifamily whole loan investors require from market prices on similar securities. This credit risk premium is net of expected funding, liquidity, and other risk premiums that are embedded in the market price of the reference securities.

Mortgage-related securities

Mortgage-related securities represent passthroughs and other mortgage-related securities classified as available-for-sale and trading, which are already reflected at fair value on the GAAP consolidated balance sheets. Mortgage-related securities largely consist of securities issued by Freddie Mac, Fannie Mae and

Ginnie Mae. They also include other mortgage-related securities such as home equity, commercial mortgage-backed, and manufactured housing securities.

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

Mortgage-related securities also include Participation Certificate residuals related to PCs held by Freddie Mac and reported in the mortgage-related securities line item. PC residuals are reported at fair value on Freddie Mac's consolidated balance sheets. Fair value for PC residuals is estimated in the same manner as described for guarantee assets and guarantee obligations for PCs, below.

Cash and cash equivalents

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

Investments

Investments principally consists of non-mortgage-related securities and mortgage-related securities held in connection with PC market-making and support activities classified as either available for sale or trading, which are reported at fair value on Freddie Mac's consolidated balance sheets. Investments also includes PC residuals related to Freddie Mac PCs reported in the Investments line item. The fair values of Investments are estimated using the methods described above in "Mortgage-related securities."

Securities purchased under agreements to resell and Federal funds sold

Securities purchased under agreements to resell and Federal funds sold principally consists of short-term contractual agreements such as 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 the GAAP consolidated balance sheets is assumed to be a reasonable approximation of fair value.

Guarantee assets for Participation Certificates

Freddie Mac does not establish guarantee assets (or guarantee obligations) for all PCs and Structured Securities under GAAP. At December 31, 2003 and 2002, Freddie Mac established guarantee assets for approximately 81 percent and 54 percent, respectively, of PCs and Structured Securities held by third parties. For more information regarding the accounting for guarantee assets related to PCs and Structured Securities, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES."

For fair value balance sheet purposes, a guarantee asset is reflected for all PCs and Structured Securities held by third parties. For fair value balance sheet purposes, guarantee fee assets are valued using the same method as used for GAAP fair value purposes. For a description of how Freddie Mac determines the fair value of its guarantee assets, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" and "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS."

Derivative assets

Derivative assets, at fair value largely consists of interest-rate swaps, option-based derivatives, futures, and forward commitments to purchase or sell securities that Freddie Mac accounts for as derivatives, which

are already reflected at fair value on the GAAP consolidated balance sheets. The fair values of interest-rate swaps are determined by using LIBOR-based yield curves to calculate the expected cash flows for both the fixed-rate and floating-rate components of the swap contracts. Option-based derivatives, which principally represent 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 sources. Derivative forward commitments to purchase or sell securities 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. Freddie Mac's fair value of derivatives is not adjusted for expected credit losses because management obtains collateral from most counterparties typically within two business days of the daily market value calculation and substantially all of Freddie Mac's credit risk arises from counterparties with investment-grade credit ratings of A or above.

Other assets

Other assets consists of accrued interest and other receivables, investments in qualified low-income housing tax credit ("LIHTC") limited partnerships that are eligible for federal tax credits, financial guarantee contracts that Freddie Mac purchased to obtain additional credit protection on certain manufactured housing asset-backed securities, real estate owned (*e.g.*, properties acquired primarily through foreclosure), fixed assets (such as property, plant and equipment), and other miscellaneous assets.

The receivables are financial instruments under SFAS 107 and are required to be measured at fair value. Because these receivables are short-term in nature, management believes the carrying amount on the GAAP consolidated balance sheets is a reasonable approximation of their fair value. For the LIHTC partnerships, fair value of expected tax benefits is estimated using expected cash flows discounted at a market-based yield. For the credit enhancements on manufactured housing asset-backed securities, 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 management's 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 management's market-based estimate.

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 deferred taxes. The net deferred tax asset (or liability) includes GAAP-based deferred taxes, adjusted for estimated income taxes on the difference between the consolidated fair value balance sheets and the GAAP consolidated balance sheets, using the statutory federal tax rate of 35 percent. This adjustment represents the incremental tax asset (or liability) related to the excess (deficiency) of GAAP-based stockholders' equity over the fair value of net assets. For fair value balance sheet purposes, the tax adjustment was recorded as a component of Other liabilities as of December 31, 2003 and as a component of Other assets as of December 31, 2002.

Other non-financial assets included in Other assets represent an insignificant portion of the GAAP consolidated balance sheets. Because any change in their fair value would not be a meaningful part of Freddie Mac's fair value of net assets business results, Freddie Mac has not adjusted the carrying amount on the GAAP consolidated balance sheets for estimates of the fair value of these non-financial assets.

Total debt securities, net

Total debt securities, net represents short-term and long-term debt used to finance Freddie Mac's assets and, for GAAP presentation, is net of deferred items, including premiums, discounts and hedging-related basis adjustments. It includes both non-callable and callable debt as well as short sales of Treasury securities used for risk management purposes.

Short-term debt is valued using third-party market prices, where available, or using an option-adjusted spread approach as described below. For long-term non-callable and callable debt with readily available third-party market prices, fair value is based on bid-side market prices obtained from brokers and dealers and

reliable third-party pricing service providers. For all other long-term non-callable and callable debt, an option-adjusted spread approach is used to estimate fair value. This option-adjusted spread approach involves using a model based on market observations, with adjustments based on management judgment, to estimate the risk premium an investor would require as compensation to accept liquidity, credit and interest-rate volatility risk. Once an option-adjusted spread has been determined, fair value is calculated by using the option-adjusted spread as an input to Freddie Mac's models to determine the estimated fair value of expected cash flows.

Guarantee obligation for Participation Certificates

As described above in "Guarantee asset for Participation Certificates," Freddie Mac does not establish guarantee obligations for all PCs and Structured Securities held by third parties for GAAP purposes. In addition, guarantee obligations are not carried at fair value for GAAP purposes in 2003. For fair value balance sheet purposes, guarantee obligations reflect the fair value of Freddie Mac's guarantee obligation on all PCs held by third parties. Additionally, for fair value balance sheet purposes, guarantee obligations are valued using the same method as used for GAAP to determine the guarantee obligation's initial fair value. For information concerning the company's valuation methodologies and accounting policies related to guarantee-related credit losses, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," and "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS."

Reserve for guarantee losses on Participation Certificates

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

Derivative liabilities

See discussion under "Derivative assets" above.

Other liabilities

Other liabilities principally consists of amounts due to PC investors (*i.e.*, principal and interest), funding liabilities associated with investments in LIHTC partnerships, accrued interest payable on debt securities and other miscellaneous obligations of less than one year. Management believes 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. Also, as described in Other assets above, management adjusts the GAAP-based deferred taxes for consolidated fair value balance sheets purposes. As of December 31, 2003, this adjustment was recorded in Other liabilities.

Minority interests in consolidated subsidiaries

Minority interest in consolidated subsidiaries represents interests that third parties hold in Freddie Mac's two majority-owned REIT subsidiaries that issued certain preferred stock to outside investors. In accordance with GAAP, Freddie Mac consolidates the REITs. The fair value of the third party minority interests in these REITs is based on the estimated value of the underlying REIT preferred stock determined by management based on a valuation model adjusted to consider the impact of embedded call options, using market-based information to the extent available.

Net assets attributable to preferred stockholders

To determine the preferred stock fair value, Freddie Mac uses a market-based approach incorporating quoted dealer prices.

Net assets attributable to common stockholders

Net assets attributable to common stockholders is equal to the fair value of net assets (the difference between the fair value of Freddie Mac's assets and the fair value of liabilities and minority interest), 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 Freddie Mac or that are collateral for PCs and Structured Securities excluding:

- $4,729 million and $8,561 million of mortgage-related securities issued by Ginnie Mae that back Structured Securities at December 31, 2003 and 2002, respectively, because these securities do not expose Freddie Mac to meaningful amounts of credit risk;
- $77,289 million and $83,707 million of agency mortgage-related securities, because these securities do not expose Freddie Mac to meaningful amounts of credit risk;
- $114,772 million and $78,392 million of non-agency mortgage-related securities held in the Retained portfolio at December 31, 2003 and 2002, respectively, because geographic information regarding these securities is not available. With respect to these securities, Freddie Mac looks to third party credit-enhancements (*e.g.*, bond insurance) or other credit enhancements resulting from the securitization structure (*e.g.*, subordination levels) supporting such securities as a primary means of managing credit risk; and
- $48,585 million and $81,674 million of non-Freddie Mac mortgage-related securities and mortgage-related securities held in our Cash and investments portfolio in conjunction with our PC-market marking and support activities at December 31, 2003 and 2002, respectively, because Freddie Mac tends to hold these securities for a short time period and the geographic information regarding these securities is not available.

See "NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO" for more information about the securities Freddie Mac holds.

Table 17.1 — Concentration of Credit Risk

	December 31,			
	2003		2002	
	Amount(1)	Percentage	Amount(1)	Percentage
	(dollars in millions)			
By Region(2)				
West	$ 295,349	24%	$ 294,681	26%
Northeast	285,789	24	264,843	23
North central	271,339	22	244,509	21
Southeast	213,646	18	200,476	18
Southwest	151,486	12	141,440	12
	$1,217,609	100%	$1,145,949	100%
By State				
California	$ 175,030	14%	$ 183,174	16%
Florida	70,970	6	67,753	6
Illinois	63,497	5	60,076	5
Texas	58,946	5	55,596	5
All Others	849,166	70	779,350	68
	$1,217,609	100%	$1,145,949	100%

(1) Calculated as total mortgage portfolio less mortgage-related securities issued by Ginnie Mae that back PCs and Structured Securities as well as agency and non-agency mortgage-related securities held in the Retained portfolio.
(2) Region Designation: West (AK, AZ, CA, GU, HI, ID, MT, NV, OR, UT, WA); Northeast (CT, DE, DC, MA, ME, MD, NH, NJ, NY, PA, RI, VT, VA, WV); North central (IL, IN, IA, MI, MN, ND, OH, SD, WI); Southeast (AL, FL, GA, KY, MS, NC, PR, SC, TN, VI); Southwest (AR, CO, KS, LA, MO, NE, NM, OK, TX, WY).

Mortgage Lenders

A significant portion of Freddie Mac's single-family mortgage purchase volume is generated from several key mortgage lenders that have entered into special business arrangements with Freddie Mac. These individually negotiated arrangements characteristically involve a lender's commitment to sell a high proportion of its conforming mortgage origination volume to Freddie Mac. During 2003, the four most significant of these arrangements together accounted for almost 58 percent of Freddie Mac's volume. Wells Fargo Home Mortgage, Inc. was the largest source and accounted for approximately 33 percent of the company's mortgage purchase volume in 2003 while ABN Amro Mortgage Group, Inc., the second largest source, accounted for approximately 12 percent of the company's mortgage purchase volume. In 2003, one mortgage lender that historically provided Freddie Mac significant business volume, Bank of America, N.A. substantially reduced its deliveries to Freddie Mac. Freddie Mac is exposed to the risk that it could lose purchase volume to the extent these agreements are terminated or modified without replacement from other lenders.

Derivative Portfolio

On an ongoing basis, Freddie Mac reviews the credit fundamentals of all of its derivative counterparties to verify that they continue to meet internal standards. Internal ratings, credit, capital and trading limits are assigned to each counterparty based on quantitative and qualitative analysis, and are updated and monitored on a regular basis. Additional reviews are completed when market conditions or events affecting an individual counterparty occur.

Derivative Counterparties. Freddie Mac's use of derivatives exposes the company to counterparty credit risk. Exchange-traded derivatives, such as futures contracts, do not measurably increase the company's 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 ("OTC") derivatives, however, expose the company to counterparty credit risk because transactions are executed and settled between Freddie Mac and the counterparty. Freddie Mac's standards for entering into OTC derivative agreements for interest-rate swaps, option-based derivatives and foreign-currency swaps include rigorous internal credit and legal reviews. Freddie Mac's 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. Freddie Mac uses master netting and collateral agreements to reduce its credit risk exposure to its 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 Freddie Mac's exposure to a single counterparty in the event of default. For example, if Freddie Mac has a gain position on one derivative and a loss position on another derivative with the same counterparty, then the gain can be netted with the loss to determine the amount of the company's net exposure to the counterparty. On a daily basis, the market value of each counterparty's derivatives outstanding is calculated to determine the amount of the company's net credit exposure, which is equal to derivatives in a net gain position by counterparty after giving consideration to collateral posting thresholds. Freddie Mac's collateral agreements require most counterparties to post collateral for the amount of the company's net exposure to them. Derivative exposures and collateral amounts are monitored on a daily basis using both internal pricing models and dealer price quotes. Freddie Mac's derivative counterparties typically transfer collateral within one to three business days based on the values of the related derivatives. This time lag in posting collateral can affect Freddie Mac's net uncollateralized exposure to derivative counterparties.

The collateral posted by counterparties serves to protect Freddie Mac against the risk of counterparty credit losses. Collateral posted by a derivative counterparty is typically in the form of cash, U.S. Treasury securities, agency securities or other mortgage-related securities. In the event a counterparty defaults on its obligations under the derivatives agreement and the default is not remedied in the manner prescribed in the agreement, Freddie Mac has the right under the agreement to direct the custodian bank to transfer the collateral to the company or, in the case of non-cash collateral, to sell the collateral and transfer the proceeds to the company.

Table 17.2 summarizes Freddie Mac's exposure to counterparty credit risk in its derivatives. This table is useful in understanding Freddie Mac's credit risk related to its derivative portfolio.

Table 17.2 — Derivative Counterparty Credit Exposure

	December 31, 2003					
Rating[1]	**Number of Counterparties**[2]	**Notional**	**Total Exposure at Fair Value**[3]	**Exposure, Net of Collateral**[4]	**Weighted Avg. Contractual Maturity (in years)**	**Collateral Posting Threshold**[5]
		(dollars in millions)				
AAA	2	$ 2,825	$ 283	$283	3.6	Mutually agreed upon
AA+	1	604	303	5	24.7	$10 million or less
AA	4	119,409	1,610	29	4.6	$10 million or less
AA−	7	237,048	7,091	250	4.1	$10 million or less
A+	6	236,944	5,922	133	5.4	$1 million or less
A	3	87,001	2,143	95	5.2	$1 million or less
A−	4	1,018	19	1	3.3	$1 million or less
Subtotal[6]	27	684,849	17,371	796	4.8	
Other derivatives[7]		141,381	—	—		
Prepayment management agreement		152,548	—	—		
Commitments[8]		89,320	101	101		
Credit derivatives		15,542	7	7		
Total derivatives		$1,083,640	$17,479	$904		

	December 31, 2002					
Rating[1]	**Number of Counterparties**[2]	**Notional**	**Total Exposure at Fair Value**[3]	**Exposure, Net of Collateral**[4]	**Weighted Avg. Contractual Maturity (in years)**	**Collateral Posting Threshold**[5]
		(dollars in millions)				
AAA	2	$ 2,438	$ 386	$ 386	4.4	Mutually agreed upon
AA+	1	609	299	13	25.5	$10 million or less
AA	3	97,229	1,161	104	4.3	$10 million or less
AA−	9	205,769	3,764	307	4.9	$10 million or less
A+	8	214,833	2,922	183	4.6	$1 million or less
A	2	83,776	1,559	48	3.7	$1 million or less
A−	2	1,655	21	3	1.8	$1 million or less
Subtotal[6]	27	606,309	10,112	1,044	4.5	
Other derivatives[7]		245,552	—	—		
Prepayment management agreement		117,219	—	—		
Commitments[8]		191,563	1,283	1,283		
Credit derivatives		17,301	4	4		
Total derivatives		$1,177,944	$11,399	$2,331		

(1) Freddie Mac uses the lower of S&P and Moody's ratings to manage collateral requirements. In this table, the rating of the legal entity (or the guarantor of the legal entity) is stated in terms of the S&P equivalent.
(2) Based on legal entities. Affiliated legal entities are reported separately.
(3) For each counterparty, this amount includes derivatives with a net positive fair value (recorded as Derivative assets, at fair value and Derivative liabilities, at fair value) including the related net accrued interest receivable/payable (recorded in Accounts and other receivables, net and Accrued interest payable).
(4) Total Exposure at Fair Value less collateral held as determined at the counterparty level.
(5) Counterparties are required to post collateral when their exposure exceeds agreed-upon collateral posting thresholds. These thresholds are typically based on the counterparty's credit rating and are individually negotiated.
(6) Consists of OTC derivative agreements for interest-rate swaps, option-based derivatives and foreign-currency swaps.
(7) Consists primarily of exchange-traded contracts. Exchange-traded derivatives do not measurably increase Freddie Mac's exposure to counterparty credit risk because changes in value of open exchange-traded contracts are settled daily through a financial clearinghouse established by each exchange.
(8) Consists of OTC derivative agreements for forward purchase and sale commitments.

Freddie Mac's uncollateralized exposure to counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, after applying netting agreements and collateral, was $796 million and $1,044 million at December 31, 2003 and 2002, respectively. In the extremely unlikely event that all of Freddie Mac's OTC derivative counterparties for these OTC derivatives were to have defaulted simultane-

ously on December 31, 2003, the maximum loss to Freddie Mac for accounting purposes would have been approximately $796 million.

Freddie Mac's exposure to counterparties for OTC forward purchase and sale commitments treated as derivatives was $101 million and $1,283 million as of December 31, 2003 and 2002, respectively. Since the typical maturity for OTC commitments is less than one year, Freddie Mac does not require master netting and collateral agreements for the counterparties of these commitments. Therefore, Freddie Mac's exposure to its OTC commitments counterparties is uncollateralized. Similar to counterparties for its OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, Freddie Mac monitors the credit fundamentals of its OTC commitments counterparties on an ongoing basis to ensure that they continue to meet internal risk-management standards.

NOTE 18: MINORITY INTERESTS

The equity and net earnings attributable to the minority shareholder interests in consolidated subsidiaries are reported in the consolidated balance sheets as Minority interests in consolidated subsidiaries and in the consolidated statements of income as Minority interests in earnings of consolidated subsidiaries, respectively. The majority of the balances in these accounts relate to the company's two majority-owned REITs.

In February 1997, Freddie Mac formed two majority-owned REIT subsidiaries funded through the issuance of common stock (99.9 percent of which is held by Freddie Mac) and a total of $4 billion of perpetual, step-down preferred stock issued to outside investors. The dividend rate on the step-down preferred stock is 13.3 percent from initial issuance through 2006 (the "initial term"). Beginning in 2007, the dividend rate will step-down to 1.0 percent. Dividends on this preferred stock accrue in arrears. The amortized balance of the two step-down preferred stock issuances as recorded within Minority interests in consolidated subsidiaries on the consolidated balance sheets totaled $1.9 billion and $2.3 billion at December 31, 2003 and 2002, respectively. The preferred stock is redeemable by the REITs under certain circumstances described in the preferred stock offering documents as a "tax event redemption." Additionally, after an initial period ending December 31, 2006, the REITs may be able to retire the preferred stock under favorable financing terms in accordance with the terms of the preferred stock. The REITs have decided not to redeem the preferred shares at this time, however, if future market conditions were viewed as favorable, the REITs may decide to redeem the preferred stock at that time. See "NOTE 14: INCOME TAXES" for more information concerning the REITs.

NOTE 19: EARNINGS PER COMMON SHARE

Basic earnings per common share are computed as net income available to common stockholders divided by the weighted average common shares outstanding (Weighted average common shares outstanding-basic) for the period. Diluted earnings per common share are computed as net income available to common stockholders divided by the weighted average common shares outstanding considering the effect of dilutive common equivalent shares outstanding (Weighted average common shares outstanding-diluted) for the period. Dilutive common equivalent shares reflect the assumed issuance of additional common shares pursuant to certain of the company's stock-based compensation plans (see "NOTE 11: STOCK-BASED COMPENSATION") that could potentially reduce or "dilute" earnings per share, based on the treasury stock method.

Table 19.1 provides computations of Freddie Mac's basic and diluted earnings per common share.

Table 19.1 — Earnings Per Common Share — Basic and Diluted

	Year Ended December 31,		
	2003	2002[1]	2001
	(dollars in millions and shares in thousands)		
Income before cumulative effect of change in accounting principles, net of taxes	$ 4,816	$ 10,090	$ 3,115
Cumulative effect of change in accounting principles, net of taxes of $24	—	—	43
Preferred stock dividends and issuance costs on redeemed preferred stock (including $—, $5 and $— of issuance costs on redeemed preferred stock)	(216)	(239)	(217)
Net income available to common stockholders[2]	$ 4,600	$ 9,851	$ 2,941
Weighted average common shares outstanding — basic	687,094	692,727	692,603
Dilutive potential common shares[3]	1,581	2,389	3,370
Weighted average common shares outstanding — diluted	688,675	695,116	695,973
Basic earnings per common share before cumulative effect of change in accounting principles, net of taxes	$ 6.69	$ 14.22	$ 4.19
Cumulative effect of change in accounting principles, net of taxes	—	—	0.06
Basic earnings per common share after cumulative effect of change in accounting principles, net of taxes	$ 6.69	$ 14.22	$ 4.25
Diluted earnings per common share before cumulative effect of change in accounting principles, net of taxes	$ 6.68	$ 14.17	$ 4.17
Cumulative effect of change in accounting principles, net of taxes	—	—	0.06
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes	$ 6.68	$ 14.17	$ 4.23

(1) In accordance with the requirements of EITF D-42. Freddie Mac restated the 2002 amount of Preferred stock dividends and issuance costs on redeemed preferred stock reported on its consolidated statements of income. For the year ended December 31, 2002, the restatement increased by $5 million the amount representing issuance costs on redeemed preferred stock and therefore reduced Net income available to common stockholders by $5 million. This caused a reduction in both basic and diluted earnings per share for the same year of $0.01 per share. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for additional information.

(2) Net income available to common stockholders is not affected by dilutive potential common shares for years ended December 31, 2003, 2002 and 2001.

(3) The effect of dilutive common equivalent shares outstanding includes: (a) the weighted average shares related to stock options (including the ESPP) that have an exercise price lower than the average market price during the period; (b) the weighted average of non-vested restricted shares; and (c) all restricted stock units. Such items are excluded from weighted average common shares outstanding — basic.

Options to purchase 3.4 million, 2.5 million and 1.0 million shares of common stock were excluded from the computation of diluted earnings per common share at December 31, 2003, 2002 and 2001, respectively, because the options' exercise price exceeded the average market price of the common shares for the years ended December 31, 2003, 2002 and 2001, respectively.

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

The following discussion, together with additional information in our Proxy Statement for our November 4, 2004 annual meeting of stockholders, is presented in accordance with Item 304 of SEC Regulation S-K. Among other things, this item requires a company that has changed its independent public accountant to disclose certain information pertaining to those events if they occurred within the company's two most recent fiscal years or any subsequent interim period. Since we changed our independent public accountant in March 2002, which was within our two most recent fiscal years, Item 304 disclosures are provided below and in our Proxy Statement for our November 4, 2004 annual meeting of stockholders.

On March 6, 2002, we announced that our Board of Directors had appointed PwC to serve as our independent public accountants for the year ending December 31, 2002, replacing Arthur Andersen LLP. The Board's appointment of PwC was made upon the recommendation of the Audit Committee after our solicitation of proposals to audit our financial statements for the year ending December 31, 2002.

The audit reports of Arthur Andersen on our consolidated financial statements for the fiscal years ended December 31, 2001 and 2000 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles.

During the years ended December 31, 2001 and 2000 and through March 6, 2002, the date of PwC's appointment, we had no disagreements with Arthur Andersen on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements if not resolved to Arthur Andersen's satisfaction would have caused them to make reference to the subject matter of the disagreement in connection with their reports. Subsequent to PwC's appointment, we undertook a revision and restatement of our consolidated financial statements for the years 2002, 2001 and 2000 which resulted in significant changes in our accounting principles and practices and our financial statement disclosure.

None of the reportable events described under Item 304(a)(1)(v) of Regulation S-K occurred within our two fiscal years ended December 31, 2001 and the interim period through the date of PwC's appointment.

During our two fiscal years ended December 31, 2001 and the interim period through PwC's appointment, we did not consult with PwC regarding any of the matters or events set forth in Item 304(a)(2)(i) and (ii) of Regulation S-K.

DIRECTORS AND EXECUTIVE OFFICERS

Directors

Information on our Directors is set forth under "Proposal 1: Election of Directors — Nominees for Election" of our Proxy Statement for our November 4, 2004 annual meeting and is incorporated herein by reference.

Executive Officers

As of September 1, 2004, the executive officers of Freddie Mac are as follows:

Name	Age	Year of Affiliation	Position
Richard F. Syron	60	2003	Chairman and Chief Executive Officer
Eugene M. McQuade	55	2004	President and Chief Operating Officer
Martin F. Baumann	56	2003	Executive Vice President, Finance and Chief Financial Officer
Ralph F. Boyd, Jr.	47	2004	Executive Vice President, General Counsel and Corporate Secretary
Patricia L. Cook	51	2004	Executive Vice President, Investments
David A. Andrukonis	47	1980	Senior Vice President and Chief Enterprise Risk Officer
Margaret A. Colon	46	1983	Senior Vice President and Chief Administrative Officer
Nazir G. Dossani	62	1993	Senior Vice President, Investments and Capital Markets
William I. Ledman	55	1994	Senior Vice President, Information Systems and Services
Stanley J.D. Martin	57	2004	Senior Vice President and General Auditor
Michael C. May	46	1983	Senior Vice President, Mortgage Sourcing, Operations and Funding
Dwight P. Robinson	51	1998	Senior Vice President, Corporate Relations
Robert Y. Tsien	51	2000	Senior Vice President, Mission Division
Jerry Weiss	46	2003	Senior Vice President and Chief Compliance Officer
John F. Woods	39	2002	Senior Vice President and Principal Accounting Officer

The following is a brief biographical description of each executive officer of Freddie Mac.

Richard F. Syron was appointed Chairman and Chief Executive Officer in December 2003. Prior to joining us, Mr. Syron was Executive Chairman of Thermo Electron Corporation, a position he assumed in November 2002. He joined Thermo Electron in June 1999 as its Chief Executive Officer and became its Chairman of the Board in January 2000. Prior to that, he was Chairman and Chief Executive Officer of the American Stock Exchange for five years, President of the Federal Reserve Bank of Boston for five years and President of the Federal Home Loan Bank of Boston for three years.

Eugene M. McQuade was appointed President and Chief Operating Officer effective September 1, 2004. Before joining us, Mr. McQuade was President of Bank of America Corporation. He also served as President and Chief Operating Officer of FleetBoston Financial Corp., which merged with Bank of America on April 1, 2004. Mr. McQuade joined Fleet in 1992 and became Chief Financial Officer in 1993, Vice Chairman in 1997, and President and Chief Operating Officer in 2002. Prior to joining Fleet, Mr. McQuade was Executive Vice President and Controller of Manufacturers Hanover Corp.

Martin F. Baumann was appointed Executive Vice President, Finance in April 2003 and Chief Financial Officer in June 2003. Prior to joining us, Mr. Baumann worked at PwC since 1969, where he was a partner from 1980. At PwC, he performed a variety of functions, including serving as the Deputy Chairman — World Financial Services Practice and as the Global Banking Leader. He also served on PwC's U.S. and World Financial Services Executive Committees.

Ralph F. Boyd, Jr. was appointed Executive Vice President, General Counsel and Corporate Secretary in April 2004. Prior to joining us, Mr. Boyd was a senior partner with the law firm Alston & Bird LLP since July 2003 and was U.S. assistant attorney general and head of the Justice Department's Civil Rights Division from

July 2001 through June 2003. From 1997 to 2001, Mr. Boyd was a trial partner with Goodwin Procter LLP, and before that, he served for six years as an Assistant U.S. Attorney in Boston. He also was an associate at the law firm of Ropes & Gray in Boston from 1987 to 1991.

Patricia L. Cook was appointed Executive Vice President, Investments, effective August 2, 2004. Prior to joining us, Ms. Cook was Managing Director and Chief Investment Officer, Global Fixed Income at JPMorgan Fleming Asset Management ("JP Morgan Fleming") since May 2003. Prior to joining JP Morgan Fleming in May 2003, she was Managing Director and Chief Investment Officer, Fixed Income at Prudential Investment Management. From June 1991 to July 2001, Ms. Cook was Managing Director at Fisher Francis Trees and Watts. Prior to that, she worked in various management positions at Salomon Brothers, Inc. from January 1979 to June 1991.

David A. Andrukonis was appointed Senior Vice President and Chief Enterprise Risk Officer in October 2003. Prior to that he served as Senior Vice President of Single-Family Capital Deployment from September 2001 through October 2003. He also served as Senior Vice President and Chief Credit Officer from August 1998 through September 2001. Prior to that, he held various positions at Freddie Mac since joining us in 1980, including Senior Vice President and General Manager of the Seller Division, Vice President of Mortgage Finance, Manager of Product Development and Pricing and Senior Economist.

Margaret A. Colon was named Senior Vice President and Chief Administrative Officer in October 2003. Prior to that, Ms. Colon served as Senior Vice President of Infrastructure Initiatives Program Management from July 2002 to October 2003 and as Senior Vice President and Single-Family Chief Operating Officer from June 2000 through June 2002. Prior to June 2000, she also has served in various other positions at Freddie Mac, including Senior Vice President — Servicer, Vice President of Corporate Finance Operations, Vice President and Assistant to the President, Vice President and Multifamily Controller. Prior to joining us in 1983, Ms. Colon was a senior auditor with Deloitte Haskins and Sells.

Nazir G. Dossani was named to the position of Senior Vice President, Investments and Capital Markets in October 2003. Prior to that, he was Senior Vice President, Investments from December 1998. Mr. Dossani joined Freddie Mac in February 1993 as Vice President, Asset and Liability Management. Prior to joining us, he served as Vice President, Pricing and Portfolio Analysis at Fannie Mae.

William I. Ledman was appointed Senior Vice President, Information Systems and Services in January 1995. He had been Vice President, Computer and Network Operations since he joined us in February 1994. Prior to joining us, Mr. Ledman held a variety of information systems-related positions with GEICO, a property-casualty insurance company, between 1974 and 1994, the most recent being Vice President, Systems and Data Processing.

Stanley J.D. Martin was appointed Senior Vice President and General Auditor in June 2004. Immediately prior to his appointment, Mr. Martin had served as interim General Auditor since February 2004. Before that, Mr. Martin served as a consultant to HSBC Bank USA from 2000 to April 2003. From 1998 to 2000, he was Chief Financial Officer and Executive Vice President of Republic New York Corporation. Prior to that, Mr. Martin was a Partner at KPMG LLP from 1982 to 1998.

Michael C. May was appointed Senior Vice President, Mortgage Sourcing, Operations and Funding in October 2003. Prior to that, Mr. May served as Senior Vice President and Chief Operating Officer of Single-Family Operations from July 2002 to October 2003. He served as Senior Vice President, Project Enterprise Execution from June 2000 to June 2002, Senior Vice President, Customer Services and Control from August 1998 to June 2000. Prior to that, since joining Freddie Mac in 1983, Mr. May served in various positions, including Vice President of Loan Prospector®, Vice President of Structured Finance, and Vice President of our Securities Sales & Trading Group. Prior to joining us in 1983, he worked at the Student Loan Marketing Association where he served as an internal auditor.

Dwight P. Robinson was appointed Senior Vice President, Corporate Relations in September 1999. Mr. Robinson previously served as Vice President, Industry Relations. Prior to that, Mr. Robinson served as Deputy Secretary of HUD and as President of Ginnie Mae.

Robert Y. Tsien was appointed Senior Vice President, Mission Division in April 2004. Prior to that, he served as Senior Vice President, Production in the Multifamily Division from October 2003, and as our Chief Credit Officer from September 2001 to October 2003. Mr. Tsien joined Freddie Mac as Vice President of Multifamily Risk Management in April 2000. Prior to joining us, Mr. Tsien was director of risk management and securitization pricing at Titanium Investment Company.

Jerry Weiss was appointed Senior Vice President and Chief Compliance Officer in October 2003. Prior to joining us, Mr. Weiss worked from 1990 at Merrill Lynch Investment Managers, most recently as First Vice President and Global Head of Compliance. From 1982 to 1990, Mr. Weiss was with a national law practice in Washington, D.C., where he specialized in securities regulation and corporate finance matters.

John F. Woods was named Senior Vice President and Principal Accounting Officer in October 2003. Prior to that, Mr. Woods served as Senior Vice President, Control and Accounting in Funding & Investments from April 2002 to October 2003. Prior to joining us, Mr. Woods was a consulting partner at Arthur Andersen.

EXECUTIVE COMPENSATION

Information regarding Freddie Mac's Executive Compensation is set forth under the section titled "Executive Compensation" of our Proxy Statement for our November 4, 2004 annual meeting of stockholders and is incorporated by reference into this Information Statement.

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

Security Ownership of Management

Information regarding the beneficial ownership of our common stock by each of our directors, certain executive officers and by all directors and executive officers as a group is set forth under the section titled "Corporate Governance-Stock Ownership" of our Proxy Statement for our November 4, 2004 annual meeting of stockholders and is incorporated by reference into this Information Statement.

Security Ownership of Certain Beneficial Owners

Information regarding the beneficial ownership of our common stock by each director nominee and certain beneficial owners is set forth under the section titled "Corporate Governance-Stock Ownership" of our Proxy Statement for our November 4, 2004 annual meeting of stockholders and is incorporated by reference into this Information Statement.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information regarding certain relationships and related transactions is set forth under the section titled "Proposal 1: Election of Directors — Transactions with Institutions Related to Directors" of our Proxy Statement for our November 4, 2004 annual meeting of stockholders and is incorporated by reference into this Information Statement.

INDEMNIFICATION AND OTHER REIMBURSEMENTS OF DIRECTORS, OFFICERS AND EMPLOYEES

Information concerning indemnification and reimbursement arrangements is set forth under the section titled "Proposal 1: Election of Directors — Indemnification and Other Reimbursements of Directors, Officers and Employees" of our Proxy Statement for our November 4, 2004 annual meeting of stockholders and is incorporated by reference into this Information Statement.

PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information regarding principal accountant fees and services is set forth under the section titled "Proposal 2: Ratification of Independent Auditors" of our Proxy Statement for our November 4, 2004 annual meeting of stockholders and is incorporated by reference into this Information Statement.

CERTIFICATION*

I, Richard F. Syron, certify that:

1. I have reviewed this Information Statement of Freddie Mac;

2. Based on my knowledge, this Information Statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Information Statement; and

3. Based on my knowledge, the consolidated financial statements, and other financial information included in this Information Statement, fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this Information Statement.

Date: September 24, 2004

/s/ Richard F. Syron

Richard F. Syron
Chairman and Chief Executive Officer

CERTIFICATION*

I, Martin F. Baumann, certify that:

1. I have reviewed this Information Statement of Freddie Mac;

2. Based on my knowledge, this Information Statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Information Statement; and

3. Based on my knowledge, the consolidated financial statements, and other financial information included in this Information Statement, fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this Information Statement.

Date: September 24, 2004

/s/ Martin F. Baumann

Martin F. Baumann
Executive Vice President and Chief Financial Officer

* These certifications do not address disclosure controls and procedures because an evaluation of the effectiveness of these controls and procedures was not performed as of December 31, 2003.

RATIO OF EARNINGS TO FIXED CHARGES[1]

	Year Ended December 31,			
	2003	2002	2001	2000
	(dollars in millions)			
Income before cumulative effect of change in accounting principles, net of taxes	$ 4,816	$10,090	$ 3,115	$ 3,666
Add:				
Income tax expense	2,202	4,713	1,339	1,504
Minority interests in earnings of consolidated subsidiaries	157	184	208	231
Total interest expense[2]	26,509	26,876	27,577	25,483
Interest factor in rental expenses	5	5	5	5
Capitalized interest	2	3	2	1
Earnings, as adjusted	$33,691	$41,871	$32,246	$30,890
Fixed charges:				
Total interest expense[2]	$26,509	$26,876	$27,577	$25,483
Interest factor in rental expenses	5	5	5	5
Capitalized interest	2	3	2	1
Total fixed charges	$26,516	$26,884	$27,584	$25,489
Ratio of earnings to fixed charges[3]	1.27	1.56	1.17	1.21

(1) Information for the year ended December 31, 1999 is omitted because we did not restate our consolidated financial statements for periods prior to 2000.
(2) In 2003, we reclassified 2002 and 2001's amortization of net deferred gains and losses on closed (*i.e.*, terminated or redesignated) cash flow hedges related to long-term debt from Income (expense) related to derivatives to the Long-term debt expense caption. These reclassifications, which increased Total interest expense and decreased Income (expense) related to derivatives, totaled $312 million and $28 million for 2002 and 2001, respectively.
(3) Ratio of earnings to fixed charges is computed by dividing Earnings, as adjusted by Total fixed charges.

RATIO OF EARNINGS TO COMBINED FIXED CHARGES AND PREFERRED STOCK DIVIDENDS[1]

	Year Ended December 31,			
	2003	2002	2001	2000
	(dollars in millions)			
Income before cumulative effect of change in accounting principles, net of taxes	$ 4,816	$10,090	$ 3,115	$ 3,666
Add:				
Income tax expense	2,202	4,713	1,339	1,504
Minority interests in earnings of consolidated subsidiaries	157	184	208	231
Total interest expense[2]	26,509	26,876	27,577	25,483
Interest factor in rental expenses	5	5	5	5
Capitalized interest	2	3	2	1
Earnings, as adjusted	$33,691	$41,871	$32,246	$30,890
Fixed charges:				
Total interest expense[2]	$26,509	$26,876	$27,577	$25,483
Interest factor in rental expenses	5	5	5	5
Capitalized interest	2	3	2	1
Preferred stock dividends[3]	315	351	310	252
Total fixed charges including preferred stock dividends	$26,831	$27,235	$27,894	$25,741
Ratio of earnings to combined fixed charges and preferred stock dividends[4]	1.26	1.54	1.16	1.20

(1) Information for the year ended December 31, 1999 is omitted because we did not restate our consolidated financial statements for periods prior to 2000.
(2) In 2003, we reclassified 2002 and 2001's amortization of net deferred gains and losses on closed (*i.e.*, terminated or redesignated) cash flow hedges related to long-term debt from Income (expense) related to derivatives to the Long-term debt expense caption. These reclassifications, which increased Total interest expense and decreased Income (expense) related to derivatives, totaled $312 million and $28 million for 2002 and 2001, respectively.
(3) Preferred stock dividends represent pre-tax earnings required to cover any preferred stock dividend requirements using our effective tax rate for the relevant periods.
(4) Ratio of earnings to combined fixed charges and preferred stock dividends is computed by dividing Earnings, as adjusted by Total fixed charges including preferred stock dividends.

ADDITIONAL FINANCIAL INFORMATION

For more information about Freddie Mac stock contact:

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

ANNUAL MEETING

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

November 4, 2004
9:00 a.m. Eastern Time
8000 Jones Branch Drive
McLean, VA 22102

Proxy material will be mailed to stockholders of record by the company's transfer agent in accordance with Freddie Mac's bylaws and New York Stock Exchange requirements.

DIVIDEND PAYMENT

Approved by Freddie Mac's Board of Directors, dividends on the company's common stock and non-cumulative preferred stock in 2003 and the first nine months of 2004 were or are expected to be paid on:

March 31, 2003
June 30, 2003
September 30, 2003
December 31, 2003
March 31, 2004
June 30, 2004
September 30, 2004

Subject to approval by Freddie Mac's Board of Directors, dividends on the company's common stock and non-cumulative preferred stock in the last three months of 2004 are expected to be paid on:

December 31, 2004

CORPORATE HEADQUARTERS

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