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OFHEO Report of Examination - Freddie Mac

United States: Office of Federal Housing Enterprise Oversight (OFHEO)

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Examination Year: 2007

Federal Home Loan Mortgage Corporation
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McLean, VA 22102

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THIS REPORT OF EXAMINATION IS STRICTLY CONFIDENTIAL
This Report of Examination (ROE) has been made by an examiner appointed by the Director of the Office of Federal Housing Enterprise Oversight (OFHEO) and is designed for use in the supervision of the Enterprise. This copy of the ROE is the property of OFHEO and is furnished to the Enterprise examined solely for its confidential use. The contents of this ROE are strictly confidential and may not be disclosed to anyone not directly associated with the Enterprise. Disclosure of the ROE or its contents by any of the Enterprise's directors, officers, employees, lawyers, auditors, or independent auditors, without authorization by OFHEO, will be considered a criminal violation of 12 CFR §1703.8 and subject to penalties under 18 U.S.C. § 641.

The information contained in this ROE is based on the books and records of the Enterprise, statements made to the examiner by directors, officers, and employees, and information obtained from other sources believed to be reliable and presumed by the examiner to be correct. The examination is not an audit and should not be construed as such. Neither the examination nor the ROE relieves the directors of their responsibility for providing for adequate audits of the Enterprise.

EXAMINATION AUTHORITY AND SCOPE

Examination Authority and Reporting Convention

This Report of Examination contains the results and conclusions of OFHEO's 2007 annual examination of the Federal Home Loan Mortgage Corporation ("Freddie Mac" or the "Enterprise") performed under section 1317(a) of the Federal Housing Enterprise Financial Safety and Soundness Act of 1992 (12 USC § 4517(a)). The OFHEO annual examination program assesses the Enterprise's financial safety and soundness and overall risk management practices. OFHEO utilizes a "CAMELSO" methodology (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Sensitivity to Market Risk, and Operations) similar to that adopted by the federal depository institution regulators to report examination results and conclusions to the Board of Directors and to Congress.

2007 Examination Scope

Our supervisory activities focused on supervision provided by the Board of Directors and senior management, asset quality, earnings performance, capital adequacy, market and interest rate risk management practices, and liquidity. Our supervisory activities also included reviews of enterprise risk management activities, corporate governance functions, internal controls, accounting practices, internal audit, information technology, and compliance with the requirements of the Consent Order the Enterprise executed on December 9, 2003 (the "Consent Order").

Rating

The CAMELSO composite rating is 3 on a scale of 1-5. Entities rated 3 exhibit a combination of financial, non-financial, operational or compliance weaknesses ranging from moderately severe to unsatisfactory. When weaknesses relate to financial condition, such Enterprises may be vulnerable to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Generally, entities with this composite rating give cause for supervisory concern because the weaknesses create some possibility of failure and they require more than normal supervision to address deficiencies. Overall strength and financial capacity, however, are still such as to make failure unlikely.

EXAMINATION CONCLUSIONS

The Enterprise remains a significant supervisory concern due to poor financial performance, deteriorating credit quality, and internal control weaknesses. Concerted efforts by the Board and management will be necessary to improve financial performance, mitigate credit weaknesses, and complete the internal controls remediation effort. Capital planning, enhancing credit governance, and strengthening systems capabilities deserve continued board and management attention.

- **Financial Performance** - 2007 financial results were poor. Significant GAAP (Generally Accepted Accounting Principles) and fair value losses are linked to the

rapid deterioration in credit performance and declines in long-term interest rates. The purchase of loans with weak underwriting, guarantee-fee pricing constraints, house price declines, and dislocation in the mortgage markets have adversely impacted financial results, flexibility, and the overall strength of the Enterprise. Losses reduced capital levels, requiring the Enterprise to issue additional preferred stock, modify risk management and business practices, reduce dividends, control growth, and actively manage balance sheet composition. Improved capital planning and income forecasting are necessary to ensure capital needs are fully assessed and capital levels are maintained at an adequate level.

- **Asset Quality** - Asset quality has deteriorated and overall credit risk has increased. Deterioration in credit quality reflects both market developments and management's strategic decision to purchase and guarantee single family mortgages originated in 2006 and 2007 with higher-risk characteristics. In addition, mortgage credit declines resulted in substantial deterioration in the fair value of the sub-prime and ALT-A AAA securities portfolio. Counterparty credit risk has increased. Management information systems have not kept pace with the deterioration in credit quality. Credit management responsibilities and accountability can be more clearly defined within the enterprise risk management function and the business area governance structure. Designation of an enterprise-wide Chief Credit Officer is recommended to ensure that an executive has direct authority and responsibility for the credit strategy and credit results of the Enterprise. Improved credit pricing and underwriting practices are being implemented.

- **Internal Controls** – Internal controls are not fully effective. While tangible progress has been made during 2007 to remediate internal control weaknesses related to financial reporting, continued efforts are necessary. Control improvements require testing/validation to evidence full effectiveness and sustainability. The Enterprise returned to quarterly financial reporting and is commencing the registration progress with SEC.

The Enterprise has: (1) a qualified and active Board of Directors (the Board), (2) a senior management team that needs to be expanded as it resolves internal controls weaknesses, returns to timely financial reporting, and must now address deteriorating credit quality. (3) met mandatory target capital surplus in all but one month of 2007, and (4) effective management of interest rate and liquidity risks. During 2007, efforts to improve the risk management capabilities across the Enterprise continued. Near term earnings prospects remain under significant pressure due to the deterioration in credit markets. Structural and economic issues in the mortgage markets continue to heighten the importance of further developing economic capital measures to better quantify risks and assess financial performance returns. Recognizing the importance of preserving capital in such an environment, management decisions over stock repurchases, dividends, investment, financing, and accounting policies still should be focused on business fundamentals and economic risk-adjusted returns.

MATTERS REQUIRING BOARD ATTENTION

Key matters highlighted in this report requiring strong Board oversight are:

- **Financial performance, analytics, and metrics**. The Board must monitor and challenge management to ensure corporate priorities, business practices, and risk management functions are properly aligned. Enterprise plans and strategies supported by realistic earnings projections, capital projections, and effective risk management practices require continued attention of the Board.

- **Credit risk management.** The Board must continue their oversight of credit quality and portfolio trends, monitoring results from strengthened underwriting and pricing changes, and ensuring progress to enhance portfolio management practices. The formation of an enterprise credit committee and appointing a Chief Credit Officer would enhance the credit governance structure.

- **Internal controls.** The Board must continue to oversee management's progress toward remediating internal control weaknesses to enable the release of accurate and timely financial statements, permit a return to controls based auditing, and build sustainable internal control governance processes.

- **Risk oversight functions**. The Board must continue to support risk and control oversight functions and the implementation of the risk control self assessment process. Enterprise Risk Management, Compliance, and the Internal Audit department made significant strides to strengthen their respective units.

- **Governance**. The Board must fill open Board vacancies, ensure proper succession plans are in place, fill the roles of Chief Executive Officer (CEO) and Chief Operating Officer, and separate the Chairman and CEO positions. It must also ensure that SEC registration takes place as planned.

BOARD AND MANAGEMENT SUPERVISION

Board of Directors and Management

The Board is aware of its oversight responsibilities and has appropriate access to management and independent advisors. The Board meets regularly in accordance with the NYSE listing standards and OFHEO's Corporate Governance Regulations, met with OFHEO twice during the year, and its committee structure is aligned with key business and risk areas. With the exception of the Chairman and Chief Executive Officer, all current Directors are independent. Term limits and age restrictions are in effect. The Board currently operates with eleven Directors, two less than its Charter mandate of thirteen. During 2008 and 2009 there will be additional planned turnover on the Board

including the Lead Director and a Committee Chair. Key activities of the Board and its related Committees during 2007 included the following:

- Reviewing and approving corporate governance documents including Corporate Governance Guidelines, Bylaws, Codes of Conduct for Directors and Employees, Delegations of Authority and Committee Charter responsibilities.

- Reviewing management reports on Enterprise priorities including the internal controls, financial reporting, enterprise risk management, and managing expenses.

- Receiving periodic updates on the legal and regulatory requirements applicable to their responsibilities, succession planning, business and financial results, asset/liability management, credit risk management, director recruiting and independence, the internal and external audit programs, employee compensation and benefits programs, allocations of resources, capital levels, and planning for SEC registration.

The Board must monitor and challenge management to ensure corporate priorities, business practices, and risk management functions are properly aligned. Enterprise plans and strategies should be informed by well-supported earnings and capital projections. In addition, effective risk management metrics require continued attention of the Board. Significant corporate governance changes were made in the later half of 2007 as credit and market conditions deteriorated. A number of historically well established risk metrics, operating practices, and business decisions have been changed to adapt to the unanticipated severity of the business environment – an indication these risk management and governance practices were not sufficiently robust in a stressed environment. For example, the deterioration in fair value necessitated changes to the economic capital framework and interest rate risk measures. Poor financial performance heightened the need to improve credit management practices, management information systems, capital management, and income forecasting capabilities.

The Board has been slow to fill the vacancy created by the departure of the former President and Chief Operating Officer (announced May 1, 2007) and separate the Chairman and Chief Executive Officer position. In addition, there is a lack of sufficient executive management depth in certain areas of the organization. A succession plan, developed by management and presented to the Board during the second half of 2007, has appropriately identified the need to focus continued attention on the development of leadership skills and increasing executive management depth. The Board should ensure that management adequately addresses these essential issues.

The Board relies on information provided and reported by Enterprise management. While no specific errors were noted by OFHEO in information reported to the Board, reporting policy guidance requires clarification concerning controls and standards for the reporting of financial and non-financial information reported to the Board. These inadequacies in the reporting process present a risk that information provided may not be accurate, complete or fairly presented.

The Enterprise has made considerable progress over the past two years in reducing voluntary attrition. Voluntary staff turnover has declined year-over-year. The corporate-wide voluntary turnover at December 2007 was 9.3% versus 11.5% for the previous year. Turnover in the 1 to 3 year levels has improved although it remains higher than desired in areas such as Finance, Internal Audit, and parts of Operations and Technology. Reliance on consultants and contingent workers has been reduced, enhanced controls around the job posting process have been instituted, and an employee headcount cap was put in place in mid-August 2007. These measures should help control overall staff-related costs that began in 2004. The Employee Performance Management process has been revamped with an emphasis on "pay-for-performance" and risk management accountability objectives.

Enterprise Risk Management
The Enterprise risk framework includes the Board's Governance, Nominating and Risk Oversight Committee (GNROC) and other relevant committees, the Enterprise Risk Management Committee (ERMC), and the Enterprise Risk Oversight (ERO) group. GNROC provides risk oversight. GNROC members are aware of Enterprise risks and risk management practices both through briefings to GNROC by ERO and through participation on other Board Committees. The ERMC is composed of representatives from all business lines and key support areas and provides reports to the GNROC. In 2007, specific topics/issues reviewed by the ERMC included: untested mortgage products (UMP), Interagency Guidance, the liquidity assessment methodology, the new products process, model governance, Multifamily loan review, the comprehensive plan, counterparty risk watch list and surveillance, Single Family corporate credit policy, Guarantee Asset/Guarantee Obligation valuations, and house price forecasts.

ERO implemented a risk dashboard to monitor and report on the quantity and direction of top enterprise risks and enhanced its standard monthly reporting package. ERO provides satisfactory reports to the Board's GNROC, Finance and Capital Deployment Committee (FCDC,) and Audit Committee. In addition, ERO assisted in the ongoing development of a revised economic capital framework which OFHEO will monitor and review as it is implemented. Concerted efforts were made to improve counterparty surveillance and reporting, better integrate risk management activities with the planning process, implement the redesigned risk controls self-assessment process, collect operational loss data, and build-out root cause analysis capabilities. ERO plans to further strengthen the capability of the group to independently produce risk metrics.

Audit
Although OFHEO is not able to fully rely on internal audit, during 2007 the internal audit function continued to develop and improve. Of particular importance, progress during the year was noted in the following areas:

- Development of a comprehensive financial audit universe and associated risk assessment;

- Expansion of the audit finance team including a Vice President;
- Improved audit report quality with findings clearly communicated and specific agreed-upon actions;
- Reliance by OFHEO on internal audit's evaluation of new systems initiatives; and
- Increased coordination between internal and external audit.

The Audit Committee actively oversees the internal audit function. The Audit Committee met 13 times during 2007. The General Auditor has sufficient interaction with the Audit Committee on a regular basis including periodic executive sessions during Audit Committee meetings. The content of reports prepared by the General Auditor for Audit Committee meetings is sufficient.

While the 2007 audit plan appropriately devoted significant resources to supporting the comprehensive plan, internal audit did not adhere to a normal rotation cycle. They are not expected to return to a normal rotation cycle in 2008. The inability to complete a full rotation cycle for several years and management's internal control self-identification process remains in the implementation phase increases the risk that control weaknesses may not be identified in a timely manner.

The General Auditor continues to be qualified and effective. While some tension between internal audit and management is natural, OFHEO has recently observed increased tension and will monitor the impact on internal audit's overall effectiveness. This is especially important due to the significant amount of work internal audit has yet to complete on the comprehensive plan as well as several other significant corporate initiatives in a deteriorating credit environment and a period of poor earnings performance.

ASSET QUALITY AND CREDIT RISK MANAGEMENT
Credit risk is a supervisory concern. Asset quality has deteriorated and overall credit risk has increased. Increased credit risk is noted in the single family guarantee portfolio, counterparties, non-agency asset backed securities portfolio, and in the multifamily segment of the business. The credit governance structure and some management information systems have not kept pace with the deterioration in credit quality.

- Deterioration in credit quality reflects market developments, pursuit of housing mission goals, and management's strategic decision to purchase and guarantee single family mortgages originated in 2006 and 2007 with higher-risk characteristics including: interest-only products, loans with secondary financing, mortgages with FICO scores less than 660, and loans with higher loan-to-value ratios. Evidence of increased risk layering has also occurred. Contract provisions precluded simultaneously increasing pricing commensurate with the increased risk. Some management information

systems and reporting have not kept pace with the deterioration in credit quality.

- Substantial fair value declines in the value of the non-agency asset backed securities portfolio occurred during 2007. While the Enterprise believes present subordination levels protect from immediate loss of principal and interest, the sub-prime mortgages underlying these securities are experiencing high delinquency, foreclosure, and severity rates. Weakness in the financial strength of bond insurers providing additional loss protection is also evident.

- The rapid dislocation in the credit markets has also adversely impacted the financial strength of a number of major counterparties including seller/servicers, mortgage and bond insurers, and other financial counterparties.

- The increased credit risk has caused operational risk to increase with the volume of current and forecasted loan workouts, foreclosures, and real estate owned properties.

- Multifamily credit quality remains satisfactory at this time. However, a relaxation and then tightening of underwriting standards occurred in 2007. A large deal closed at year-end has high operational and credit risk.

Single Family

Throughout 2007 and at a level much higher than management's plan, the Enterprise continued to purchase and guarantee higher-risk mortgages. These purchases have performed more poorly than expected. The performance can be attributed to mortgages with high (loan-to-value) LTVs, non-owner occupied properties, low FICO scores, high debt-to-income ratios, limited or no documentation, and underwritten through non-Freddie Mac lending systems. Evidence of risk layering is apparent as a large number of loans share multiple risk attributes. The risk layering of low FICO scores (<620) and high LTV (>90%) account for 2% of the 2007 flow purchases and represent approximately 21% of the early payment defaults.

A small number of large sellers have delivered a disproportionate amount of the poor performing loans. During 2007, internal management reports showed increasing economic capital allocations and significantly lower than expected profitability. Reduced returns are driven primarily by an inability to adjust pricing, the decline in house prices, and increases in expected default costs. Delinquencies continue to rise and loss severities are increasing.

The credit guarantee business grew faster than planned – 18% versus 11% and exceeded overall mortgage debt originations as the Enterprise was providing liquidity to the market. New higher risk business coupled with declining house prices are reflected in

deteriorating performance metrics – increasing serious delinquent rates, transition rates, and loss severity rates -- triggering increases to credit loss forecasts, provisions and reserves. Management expects higher incidences of Real Estate Owned (REO), higher average REO balances, and lower recoveries on new REO's.

Total credit related costs increased sharply during 2007. They rose from $0.9 billion in 2006 to an estimated $6.4 billion for 2007. The 2007 provision expense, accounting for half of the total increase in credit costs, reflects the deteriorating credit environment and the higher credit risk inherent in the 2006 and 2007 books. The allowance/reserve for losses rose from 4.0 basis points of the total credit book of business at the end of 2006 to 15.5 basis points at the end of the 2007.

The other major credit costs are losses on seriously delinquent loans purchased from security pools under SOP 03-3 and losses on pools priced so that the initial guarantee obligation exceeded the guarantee asset ("certain credit guarantees" or Day 1 losses). Both SOP 03-3 and Day 1 losses increased substantially during 2007 and in aggregate account for approximately $3.9 billion in credit costs. SOP 03-3 losses increased significantly due to an increased volume of serious delinquencies (120 days) coupled with a steep decline in the market prices for delinquent loans during the second half of 2007. Increased Day 1 losses were driven by sharp increases in the guarantee obligation driven by higher expected credit defaults, inability to increase pricing, and an increased market risk premium. The increased market risk premium was particularly pronounced in the last few months of 2007.

Total credit-related costs are expected to remain high during 2008. High provision expenses, increasing REO expenses, and continued Day 1 losses will be major contributors to credit expenses in 2008. Management's 2008 forecast projects total credit expenses to reach $5.0 billion.

As of December 31, 2007, the overall portfolio had an average FICO of 723 and LTV at 63% versus an average FICO of 725 and LTV at 57% as of December 31, 2006. Loans with FICO scores less than 620 have increased from 3.7% at December 31, 2006 to 4.2% at year end 2007. Mortgage insurance coverage (required only for mortgages with LTVs greater than 80%) was at 12% of the overall portfolio and credit enhancements levels remain low at 7%. The serious delinquency rate for December 2007 was 65 bps versus 42 bps for at year end 2006. The overall level of 90-day delinquencies and the transition rates from 90 days delinquent to foreclosure are also increasing. December 2007 REO inventory was at 14,394 versus 8,785 at December 31, 2006 – a 64% increase year-over-year. REO was up due to weak economic conditions in the North Central region and house price declines in Western (California and Arizona) and Southeast (Florida) regions. Recovery rates are at 81%, but are expected to decline to 75% in 2008. Commencing in 2008, modeled payment shock forecasts demonstrate increasing risk.

The deterioration in overall credit has stressed the existing credit governance structure. The implementation of enterprise credit committee and designation of a Chief Credit Officer responsible for the Enterprise's credit strategy and credit results would augment

and strengthen the credit governance structure. The majority of credit risk management has been implemented through the Enterprise risk oversight function. While the oversight function has successfully evolved over the prior 24 months and has become increasingly effective, their role should augment but not replace the role of a Chief Credit Officer for the Enterprise. It will also enable consistent policy execution, standardized management information systems, defining the corporate-wide credit risk profile, and improve coordination between sourcing, mission, and credit risk management.

Management took positive actions to address increasing credit risk and external market events. During 2007, the Enterprise issued a statement on their efforts to comply with the subprime and non-traditional mortgage guidance's, bulletins and industry letters to tighten up underwriting guidelines specific to initial interest mortgages, declining markets, and condominium units. From August through December, four Bulletins and Industry Letters were issued announcing pricing changes to post-settlement delivery fees. They are expected to provide positive Return on Equity (ROE) impact; however, changes will not be fully implemented and begin to be reflected in the financials until after 2Q2008. Changes are being made to the loss mitigation business model to delegate more activities to the servicer with validation by Enterprise personnel along with the steps to expand outsourcing capabilities in non-performing loan areas.

As a result of a higher credit risk profile, operational risks related to personnel, technology and reporting are emerging. The Quality Control (QC) department is under increasing pressure. The inventory of non-performing loans and early payment defaults is increasing substantially. In addition, management terminated the contractor for replacement of QCs automated system and is now finalizing terms with a new vendor. System deficiencies have been outstanding per a 2005 Audit report. Improved functionality is necessary for QC process improvement efficiencies and for meaningful risk management reporting. The Servicing and Asset Management (SAM) unit will also be stressed by increased inflows to foreclosure, the volume of loans being considered for a workout, and the increased inflows to and longer marketing times for REO. While management has a sound, well-conceived capacity plan, the plan's success is contingent on the Enterprise's ability to effectively outsource non-performing loans (NPL) functions when this expertise is in high demand and ability to effectively manage the outsourced vendors on a national scale.

Asset Backed Mortgage Securities

During 2007, asset backed mortgage securities (ABSs), especially those backed by subprime mortgages, experienced a significant decline in fair market values due to spread widening. As of December 31, 2007, the subprime ABS portfolio including Alt-A's and HELOC's declined $13 billion (approximately 7% below amortized cost) in market value. As a result of the same widening in credit spreads, commercial mortgage backed securities (CMBS) portfolio also experienced sharp price declines during the year. At year end, the asset backed securities market continued to experience limited market liquidity with wider than historical bid-ask spreads. Management continues to closely

monitor delinquencies, prepayment speeds, and loss severities to stress test cash-flow models.

Despite the worsening performance of the underlying mortgage pools, a majority of the subprime ABS book continues to accrue additional subordination levels. As of year end, the estimated subordination is 33% (including monoline wraps). However, some bonds have performed weaker than the aggregate portfolio. Although some of these bonds within the portfolio have been downgraded and are on the internal watch list, no impairments have been recorded. The table summarizes current delinquencies and subordination levels for the subprime ABS portfolio as of year-end.

PORTFOLIO	UPB ($bn)	SUBORDINATION (W/ MONOLINEs)	60+ DELINQUENCIES AS % OF UPB
Subprime 1st Lien	$100.3	35.8%	21.0%
Closed-End 2nd Lien	$1.0	77.4%	7.1%
Alt-A	$25.1	16.2%	7.5%
MTA-ARMs	$21.1	23.2%	7.2%
HELOC	$4.5	100.0%	8.2%
TOTAL	**$152.0**	**33.0%**	**16.4%**

While present subordination levels protect from immediate losses, worsening performance of the underlying mortgages and weakness in the US housing markets remain a significant concern. Additionally, approximately $11billion of the ABS portfolio was insured by third-party bond insurers. Most of these insurers have been recently downgraded or put on negative watch. Their ability to honor their financial guarantees is uncertain at this point. This uncertainty increases the credit concern associated with this portfolio.

Multifamily

Credit quality of the multifamily mortgage and CMBS portfolios remain satisfactory at this time; however, risk is increasing. Consistent with management's plan, the Enterprise purchased and guaranteed higher-risk multifamily mortgages. Current purchases have a large interest only component. There was expansion of the delegated underwriting program into product areas with higher operational risk and higher credit risk attributes (non-stabilized and construction properties).

Multifamily mortgage credit quality indicators reflect a weighted average debt service coverage ratio of 1.77 and a weighted average LTV of 60%. Approximately 9% of the portfolio has a debt service coverage ratio of 1.10 or less. The portfolio is reasonably diversified by geography and borrower. Washington and New York have the highest concentration by MSA. Delinquencies and historical losses are well controlled. At this time the CMBS are also performing reasonably well with low delinquencies and adequate levels of credit subordination.

Although absorption rates are positive and vacancy rates remained low, management took positive actions to address increasing credit risk and changing external markets. The

Enterprise set operating limits for geographic concentration. In addition, Multifamily developed and implemented a risk rating system and risk-based transaction approval process. Finally, Multifamily developed and deployed an underwriting refinance test that takes into account forward looking capitalization rates. During 2007, internal loan review results of the multifamily business indicate improvements. Underwriting quality is acceptable and consistent with the policies.

Enterprise Counterparties

Counterparty credit risk continues to increase. Counterparty exposures are material. A significant deterioration in the financial condition or a ratings downgrade of a top counterparty could adversely impact the Enterprise.

Within the Credit Risk Oversight group, Counterparty Credit Risk Management (CCRM) provides satisfactory oversight of aggregate counterparty risks and exposures at the Enterprise level for all counterparties. During 2007, counterparties were particularly stressed as a result of higher than anticipated write-downs and increased provisions due to subprime mortgage exposures, weaker revenues, reduced margins and unprofitable secondary market executions. As of December 31, 2007, total counterparty exposure (excluding Federal Funds transactions) was $2.9 trillion – up from $2.3 trillion at December 31, 2006. The top ten servicers process approximately 80% of the servicing book. The largest servicer, Wells Fargo, processes approximately 28% of the $1.7 trillion single family loan servicing book. Countywide and Bank of America combined represent an additional 13% of the single family loan servicing book. Industry mortgage insurance companies (MIs) also represent a significant level of counterparty risk for the Enterprise, with the seven largest companies providing insurance for 18% of the guaranteed portfolio and 3.5% of the $58 billion risk in force. Additionally, it is estimated that approximately $6.8B of the non-agency mortgage asset backed portfolio (4.3%) has mortgage insurance coverage as part of the overall credit enhancement. During 2007, the Enterprise successfully terminated four counterparties -- Mortgage Lender's Network (MLN), Homebanc Mortgage, American Home Mortgage and MVB Mortgage with no adverse consequences to the Enterprise. With New Century's bankruptcy filing in April, Legal and management worked with an outside party to protect the Enterprise's interest in the servicing portfolio.

CCRM continued intense monitoring through the watch list and surveillance framework. CCRM improved management reporting with inclusion of several reports in the ERM Committee's standard report set; e.g., the Counterparty Credit Profile report and Counterparty Watchlist Summaries for Non-Diversified Top 200 Single Family Servicers and for financial guarantors, mortgage insurers, banks, broker dealers, and multifamily. A Counterparty Tear Sheet is under development for routine updates on counterparty sectors. Specific plans and/or actions to mitigate counterparty losses were developed or updated, which included: expanding the ability to retrieve loan files and servicing tapes from Seller/Servicers during periods of financial stress; limiting exposures; restricting business activities; seizing the counterparty's portfolio; stress testing counterparties' balance sheets and exposures; monitoring internal ratings; requiring collateral requirements; terminating riskier contract terms; and negotiating buyout protection from credit enhancement providers. The movement of CCRM from the Investments and

Capital Markets group to Credit Risk Oversight has had a positive impact on counterparty credit risk management.

OPERATIONS

Operational risk management requires improvement. Internal controls related to financial reporting, while substantially improved, are not considered fully effective. During 2007, measurable progress to improve internal controls related to financial reporting and the technology environment has been achieved. During the year, management documented the majority of key financial controls and procedures related to financial disclosures, designed new controls, and simplified several accounting processes. At year end, management has not completed operational effectiveness testing of internal controls, provided sufficient evidence of sustainability, or fully implemented the management self-assessment process.

The Enterprise must build on the progress achieved in 2007 with continued focus toward the completion of the inter-related components of the comprehensive plan. The continued level of anticipated change and manual processes associated with efforts and activities to improve controls, improve reporting timeliness, implement a number of accounting policy changes will continue to stress the internal control environment.

The Comprehensive Plan, developed to address the controls weaknesses, is a multi-faceted plan intended to:

- remediate known control weaknesses,
- document the business control designs through the end-to-end (E2E) process design review,
- remediate and document information technology general controls (ITGC), and
- implement automation improvements to enable a return to timely financial reporting.

Governance and management over the comprehensive plan improved during 2007. Board oversight intensified as the GNROC of the Board met monthly with senior executives to monitor progress toward completion. The Audit Committee of the Board also continued close monitoring. Enterprise senior management met frequently in committee to monitor and direct activities of plan components. Operating management changes associated with ITGC documentation and remediation, E2E business design review, and the Finance Internal Control Organization (ICO) contributed significantly to the progress achieved in 2007.

Senior management established the Finance ICO in late 2006 to manage the comprehensive plan and to ensure the Enterprise establishes a sustainable internal control environment to meet the requirements of Sarbanes-Oxley (SOX) legislation. By year-end, the professional staff, augmented by consultants, had established policies and procedures to ensure that control documentation is continuously updated and designed procedures to implement management's quarterly risk and control assessment process.

The status of individual components of the Comprehensive Plan activities at year-end 2007 is as follows:

Material Weaknesses and Significant Deficiencies

- Progress toward the remediation of material weaknesses and significant deficiencies has been made. Management plans for independent testing of these controls and the issuance of an opinion on their effectiveness at year-end 2008.

End-to-end business process design review

- Documenting controls over financial reporting is nearing completion. Management's full assessment of the control design has not been completed. Controls have not been tested for effectiveness. Control documentation, remediation and validation activities will continue through 2008.

Information Technology General Controls (ITGC)

- ITGC controls are implemented and effectiveness testing by management has been completed. Independent reviews of the control design are in process. Both independent and management testing of internal control effectiveness are planned through 2008. A new systems development life cycle framework has been developed and is being implemented. Compensating controls are being relied upon until the life cycle methodology is fully deployed.

Close Process Improvements/ Timely Financial Reporting

- Continued improvements in reporting process timelines have been made during 2007. Additional efforts are necessary to achieve SEC timelines and evidence sustainability.

Information Technology

Risk in the corporate computing environment remains elevated. During 2007 management evidenced measurable progress in delivering and implementing several financial systems upgrades. The investment accounting systems (Eagle and the enhanced portfolio sub-ledger) were deployed. Eagle became the system of record January 1, 2008. Although delayed, the deployment of Summit (debt and derivatives accounting) is planned during first quarter 2008. Phoenix (loan and amortization accounting) is planned for deployment in second quarter 2008. These delays are not the first for these systems, and their re-occurrence continues to impede the establishment of fully effective operational controls in these areas. Management is actively managing the development of each of these systems and continues to rely on compensating controls.

In addition to hiring a new Executive Vice President, a number of other changes and reorganizations occurred in FMOT in 2007. These included replacing 76 percent of officers and 65% of senior directors with personnel either new to Freddie Mac or new to the Information Technology Department. Improvements related to these changes are evidenced in several major projects and remediation efforts such as Information

Technology General Control (ITGC), End User Computing applications (EUCs), Information Security, Business Continuity Planning and system implementation.

Management continues to work on strengthening its systems development life cycle methodology in order to implement major automation projects in a timely and well-controlled manner. This process cannot be fully validated until a sufficient number of systems implementations have complied with the revised process.

- ITGC remediation activities were completed. Independent review and effectiveness testing will continue through 2008.
- A high number of EUC applications exist. The full implementation of three major systems should substantially reduce the number of EUCs during 2008. Management implemented comprehensive EUC inventories and established control guidelines for EUCs. However, manual processes coupled with the number of EUCs increase data quality risk and stress the internal control environment.
- Data quality improvement initiatives continue. While progress to improve quality has commenced with the identification of critical financial data elements, considerable work remains to complete the architecture and supporting infrastructure.
- Management has made progress with the development and implementation of a comprehensive, enterprise wide Business Continuity Planning (BCP) governance process. A Vice President was hired to head the BCP effort. Progress to establish an out-of-region data center continues. A contract was signed during 4Q2007 for an out-of-region "warm site" recovery capability.

MODEL RISK

Model risk remains high due to the wide application of models used in business decisions, financial reporting, and the rapid deterioration in the mortgage markets. The rapid change in the credit conditions in the mortgage markets has increased model risk as models have become less reliable and require adjustment when the internal and economic conditions are outside of historical experience. Models are estimated using selected historical experience as a guide. When no historical experience exists to provide insight for model builders, models may fail to produce accurate projections or may require greater management judgment. Such circumstances test management's ability to rapidly and accurately adapt models and revise associated assumptions about the future.

Model risk management requires improvement, although considerable progress has been made during 2007. Corporate policies and oversight procedures were strengthened and control processes have been enhanced. Management reports provide timely warning of model performance outside of normal ranges. The results from the improved process highlight the need for consistent, effective model oversight and change controls.

ACCOUNTING

During 2007, the Enterprise responded to various accounting challenges: material weaknesses in disclosure and financial reporting controls; achieving timely publication of financial reports (i.e., within SEC-required time-frames, although Freddie Mac is not yet registered with the SEC); the issuance of new accounting standards by the Financial Accounting Standards Board; and later in the year deteriorating credit markets. OFHEO finds Freddie Mac met these challenges during the year, but not always in ways entirely satisfactory to OFHEO. The details and desired improvements are discussed below. We also note that during the past year, OFHEO at times experienced untimely and incomplete responses to our requests for information. This situation was evident during the early part of our review of Freddie Mac's cash flow hedge accounting. Also we found certain issues in the Enterprise's selection and implementation of accounting standards, which raise concerns regarding the quality of capital and will need further review. To systematically address the recent new fair value accounting standards OFHEO is developing accounting guidance. The guidance is being designed to foster a consistent, transparent, and economically faithful implementation of the standards for both Enterprises. Following are some of the more significant issues OFHEO is reviewing at the Enterprise:

Reported Material Weaknesses - On March 23, 2007 Freddie Mac published its Annual Report with audited financial statements for the fiscal year ended December 31, 2006. Management reported it had not completed its evaluation of internal controls over financial reporting. Based on the persistence of some material weaknesses at December 31, 2006, management of the Enterprise concluded that its internal controls over financial reporting were not effective on December 31, 2006. A number of factors, such as the complexity and interdependent nature of the remediation efforts, as well as the uncertainty regarding the quality and sustainability of controls impacted the Enterprise's effort to remediate internal controls weaknesses and deficiencies. The Enterprise's external auditors did not report on management's assessment of the effectiveness, or the actual effectiveness, of the Enterprise's internal control over financial reporting as of December 31, 2006. A lot of progress was made during 2007. The 2007 annual report indicates that all material weaknesses have either been remediated or remediation activities have been implemented which, if successfully tested for sustainability, would lead to full remediation of all material weaknesses. Therefore, during 2008, the Enterprise will have to test the sustainability of the new controls and address various significant deficiencies through continued improvement in the accounting and financial reporting infrastructure.

Securities and Exchange Commission (SEC) Registration - The Enterprise is not yet registered as a public company with the SEC, but it has announced its intention to do so. It made progress towards that goal with policy and operational changes made during 2007, which increase the likelihood of application for registration by the mid-2008. The Enterprise has significantly reduced the time it takes to produce financial statements. With the issuance of its 2007 Annual Information Statement, Freddie Mac has demonstrated that it can meet the annual financial reporting time frames required to be a public company registered with the SEC. OFHEO will continue to closely monitor this

in 2008, including Freddie Mac's ability to meet the SEC's tight quarterly reporting timeframes.

Accounting Policies – The Enterprise's management continues to develop and update its accounting policies. However, our reviews concluded that further work will be required to develop complete accounting policies and procedures for Freddie Mac to meet the standards articulated in OFHEO's *Accounting Guidance*. During the past year, to assess Freddie Mac's design and implementation of its accounting policies, OFHEO performed several targeted reviews including the following: securities which have become impaired in value (FAS 115); the fair value option (FAS 159); and credit loss reserves (FAS 5), as discussed below.

Impaired Securities Accounting – During 2006 and the beginning of 2007, we reviewed Freddie Mac's accounting policies and procedures for impairments in the values of its investment securities. We note that Freddie Mac had made some evolutionary changes in this area to help deal with the challenges posed by the current credit markets. Our initial findings, issued in mid-2007, were that we believed Freddie Mac's policies were appropriate as written. However, in the fourth quarter of 2007 we identified that Freddie Mac's actual evaluation of securities for impairment was not being carried out consistent with its written policy and how OFHEO understood the process to work. The effect of this departure from the written policy on the fourth quarter impairment process was that management did not record certain impairments that the policy as it was written would have required, based on price declines and ratings downgrades.[1] Given the current situation in the credit markets, further declines in the values and credit rating downgrades of mortgage-related securities may occur in the coming year and, possibly, become material to core capital. OFHEO will continue to monitor the Enterprise's implementation of its impairment accounting policies in the coming year to ensure safe and sound operations.

Fair Value Option Implementation – Pursuant to FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, the company elected for the change to fair value accounting roughly 11% of total assets and 3% of its total liabilities. Freddie Mac noted that they made this election for certain securities in part to hedge the fair value changes in the guarantee asset and that they plan to do this type of hedging on an ongoing basis. Freddie Mac reported a transition gain, under the fair value option election, of approximately $1 billion, which OFHEO notes provided an immediate boost to Freddie Mac's regulatory capital, as of January 1, 2008. Most of the transition gain is due to the election of securities, for the change to fair value accounting, which carried an unrealized gain in accumulated other comprehensive income. For the most part, Freddie Mac did not select securities for fair value accounting, which had deferred losses in accumulated other comprehensive income, of which there were considerable to choose from. In particular, as of December 31, 2007, on available-for-sale securities Freddie Mac had gross deferred losses of about $15 billion and deferred gains of only about $4.3 billion. The deferral of these net losses in accumulated other comprehensive income provide a

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[1] Management instead performed an internal cash flow analysis and concluded that a loss was not "probable."

regulatory capital benefit to Freddie Mac of about $7 billion (i.e., $15 billion gross gains minus $4.3 billion gross losses, net of a 35% tax effect. Going forward, subsequent to December 31, 2007, the Enterprise will continue to have the option of selecting between mixed attribute accounting (FAS 115) and fair value accounting (FAS 159) for its new purchases of securities and new issuances of debt. During the coming year OFHEO plans to further study Freddie Mac's application of the fair value option to confirm that it is consistent with management's articulated strategy and with OFHEO's guidance.

Reserves for Credit Losses - We began a limited review of the firm's approach to the calculation of its reserves for credit losses. During 2007, OFHEO became concerned with the impact of the deteriorating credit markets upon the earnings, regulatory capital, and general financial condition of the Enterprises. Accordingly, we paid special attention to the impact of the rising rates of delinquencies in the calculation of the loan loss reserves at Freddie Mac. We are generally satisfied with Freddie Mac's application for providing adequate reserves and related loss recognition in the income statement. We identified various issues that we plan to follow up on during the coming year, related to how the Enterprise has adapted its reserve calculation methodologies to the unique credit environment which came about in the latter part of 2007. For example, the Enterprise had to make significant adjustments to its credit reserve models and model outputs, to take into consideration the much higher default rates experienced in connection with mortgage loans made during 2006 and 2007, as compared to earlier years. OFHEO will continue to study the reserve computations of the Enterprises, as the credit situation continues to unfold and evolve during 2008.

During the remainder of 2008, OFHEO will continue to assess these and other areas.

MARKET RISK

Interest rate risk management is satisfactory although certain metrics traditionally relied upon by the Enterprise to measure and report exposures were not mathematically robust or informative in light of the dramatic decline on the Enterprise's fair value of equity. The year presented significant Enterprise wide challenges with unprecedented widening of spreads and extreme volatilities resulting in the breaching of management's operating limits for interest rate risk. The year's events highlight the need for reassessing the continued robustness of certain qualitative and quantitative aspects of the Enterprise's risk management framework. Management successfully managed to monitor, control and report on the Enterprise's sensitivity to interest rate risk in a manner commensurate with the nature and complexity of the Enterprise's activities and under very challenging market and business conditions.

During 2007, the fair market value of portfolio assets, liabilities and capital came under significant pressure due to extraordinary changes in market rates, spreads and volatility. Management maintained interest rate risk exposures at low levels throughout most of 2007 although exposures increased in the fourth quarter ending the year at a moderate level. Management used financial derivatives, including swaps, options and futures, as well as derivatives embedded in debt instruments (e.g. callable debt) to maintain

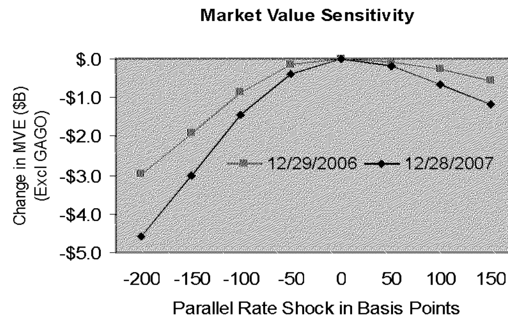
manageable interest rate risk exposures within desired risk ranges and kept exposures generally stable. The notional value of derivative counterparty party exposure grew from $758 billion at December 31 2006 to $1.3 trillion at year-end 2007 as a result increased hedging activities associated with high interest rate volatility.

Mortgage-Debt Option Adjusted Spread (OAS) widening, due to credit and liquidity concerns, resulted in over $23 billion decline in fair value of net assets attributable to common stockholders, before capital allocation. Management does not hedge this risk as there are limited actions the GSE can undertake to hedge this risk given their business model. Management plans to hold these assets to maturity, and absent permanent impairment, expects not to be exposed to this risk.

The Board-approved 2007 asset/liability management (ALM) policy and plan are formally documented and are designed to guide management to maintaining interest rate risk exposures within prudent and reasonable ranges and limits to minimize the need to engage in dramatic and expensive rebalancing activities. The Board revisits policies and limits annually. Several senior management committees and subcommittees as well as the independent Market Risk Oversight (MRO) group - within the Enterprise Risk Management group, perform ongoing daily oversight and monitoring of Enterprise exposures relative to established expected positions, management limits, and Board limits. Established escalation and communication plans are in place in the event expected positions or limits are breached. In addition, two Board committees—the Finance &Capital Deployment Committee and the GNROC—monitor the Enterprise's results against approved limits and performance objectives.

Management reports provide the information necessary to inform and support decision-making at appropriate levels of the organization. Risk measurement is performed both in-house and through an outside service provider (BlackRock Solutions) and is reported daily.

Management conducts daily sensitivity analyses and stress tests. The Enterprise's market value of portfolio equity (excluding the guarantee fee business) has become significantly more sensitive to rate changes compared to 2006. The chart indicates that the market value of portfolio equity (MVE) is relatively protected against small changes in rates but vulnerable to sudden, significant changes in rates.



The Enterprise also conducts a variety of stress tests to estimate maximum expected market value loss with 99% confidence. The ALM–related 10-day value at risk (duration, convexity, and volatility) as of year-end 2007 was $282 million.

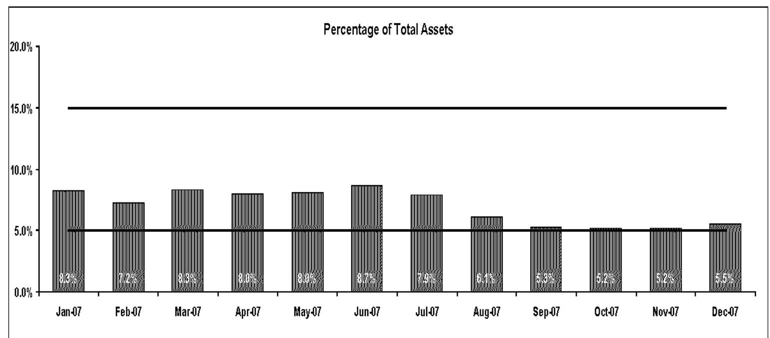
While exposure to interest rate risk was satisfactorily controlled through the year, management operating limits (PMVS), for which fair value of equity serves as the denominator began to be approached and breached in the fourth quarter as rates fell sharply, spreads widened, and fair value of equity declined. As exceptions occurred management effectively adhered to escalation procedures and MRO conducted monitoring activities in accordance with existing policies and procedures acting promptly to require justification and actions to resolve exceptions.

It is of concern that revisions to key metrics used internally and for external disclosure purposes were not foreseen in a timely fashion. While best practices support metrics being regularly re-evaluated for their robustness and continued suitability during highly volatile time periods, interest rate risk measurement is not an exact science, and implementing revisions during fast moving events may address current issues but may not result in well tested or sustainable enhancements to measurement metrics.

Escalation procedures operated as designed. On occasion, management as well as the oversight function sought to remedy breaches of limits by readily proposing revisions to risk limit, metrics and reporting. As spreads continued to widen and the fair market value of common equity (MVE) declined sharply to near zero at year-end 2007, management determined that indicative risk measures using MVE in the denominator, such as PMVS, had ceased to be mathematically robust or informative as the computed percentage ratio grew exponentially. In response, management proposed to the Board a change in the way the ratio was computed and reported internally to a percent of available economic capital, and to revise public disclosure of the PMVS metric from a percentage change to a dollar-change.

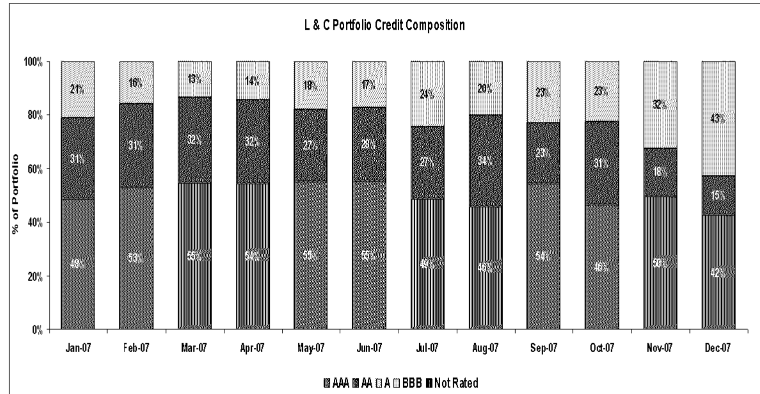
LIQUIDITY

Liquidity management is satisfactory. Adequate guidance exists for the types, and credit quality of investments suitable for inclusion in the Liquidity and Contingency (L&C) portfolio. Management is able to effectively forecast liquidity needs and has adequate policies and procedures in place for forecasting short- and long-term liquidity needs. The Enterprise has access to sufficiently diversified funding sources to meet present and anticipated liquidity needs. Management has adequate framework to effectively identify, measure, monitor, and control the Enterprise's liquidity position.



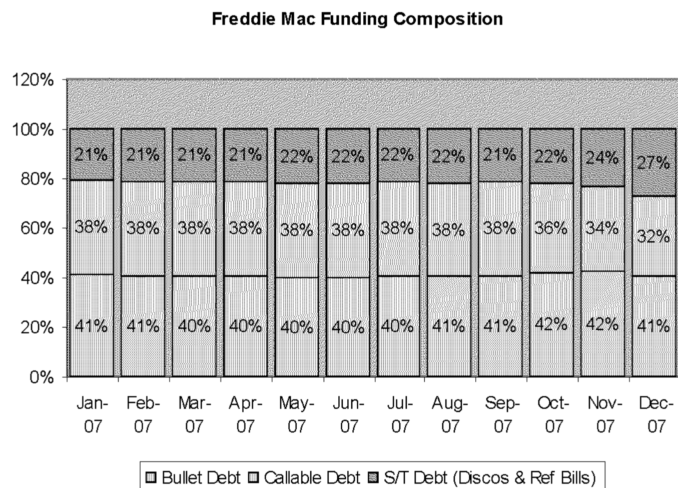
Size: During 2007, the L&C portfolio balance declined from a high of $71.3 billion in June to a low of $40.0 billion in November. As a percent of on-balance sheet assets this brought the November L&C balance to just over the Board's 5% minimum limit, from a

high of about 9% in June. The reduction was a result of management's deliberate decision to buttress available capital depleted by rising credit losses. In the last part of 4Q07, management requested Board approval to change the L&C portfolio limit from the 5% of on-balance-sheet assets to the greater an amount equal to that of $20 billion or maximum of the next 10 business days' liquidity needs. In addition, a new management limit was instituted that required a 1-day cure period if the $20 billion limit is breached. A key driver for the policy change is the declining L&C balance and the segregation of P&I payments, previously part of the L&C calculation, into a separate off-balance sheet account at the Federal Reserve. In early December 2007, the board approved the limit change. However, OFHEO requested, and management continues to report both metrics pending OFHEO review.



Credit Quality: During the year, roughly 80% of average daily balances of the L&C portfolio represented assets rated AA or better. However, the proportion of AA to single-A rated securities has fluctuated significantly in recent months, with double-A rated assets experiencing a decrease accompanied by an increase in the percentage of single-A rates securities. AA-rated assets declined from a high of about 34% in August of 2007 to a low of 18% in November. During the same period, single-A rated assets increased from 20% to over 30% of total average L&C balances. Daily marks indicate the aggregate liquidity portfolio maintained a tight par price range throughout the year ranging from a low of 99.99% to 100.9%. At year end, management selected several balance sheet categories for inclusion under 'fair value option' which did not include the liquidity portfolio. Not including the liquidity portfolio under the 'fair value option' merits further evaluation by management.

Funding Liquidity: The Enterprise maintains sufficiently diversified sources of funds to meet present and anticipated liquidity needs. Management maintained stable proportion of short to long-term funding throughout the first three quarters of the year. As volatility increased significantly during the 4th quarter and optionality became increasingly expensive, there was a noticeable planned shift in the composition of short term funding with an increased reliance on



discount notes and corresponding decreased reliance on callable debt.

Policies & Procedures: The liquidity management policies, procedures, and a contingency plan identify authorized investments, exposure limit rules, and independent review requirements. Procedures exist that define what constitutes a liquidity event and the escalation steps to be followed during such an event. Risk limits are in place to ensure sufficient liquidity levels. Management evaluates limits and pertinent metrics on a daily, weekly, and monthly basis and conducts regular stress tests of the liquidity and contingency portfolio. Overall reporting is satisfactory.

Oversight: The Market Risk Oversight (MRO) group monitors exposures relative to risk limits on a regular basis. While MRO currently lacks the ability to independently and effectively validate the reported metrics, significant progress toward the completion of an in-house risk measurement capability is reported.

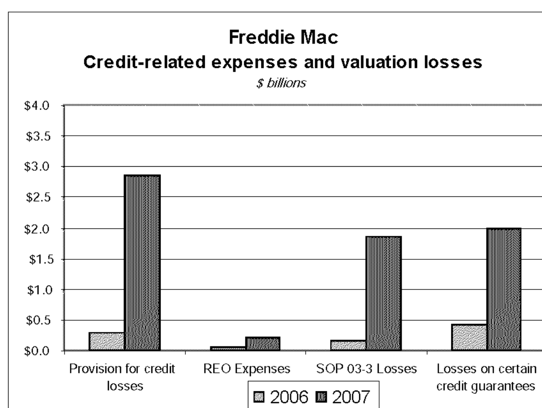
EARNINGS

2007 was a difficult year for financial performance. A confluence of market and company specific factors – deterioration in the housing and credit markets, substantial declines in interest rates in the second half of the year, and replacement of maturing debt – resulted in the Enterprise reporting a GAAP net loss of $3.1 billion. Freddie Mac has never before reported an annual net loss until this year.

GAAP Financial Performance

Pre-tax income declined by $8.3 billion from year end 2006 as a result of substantially higher credit related expenses and valuation losses, higher losses on derivatives and lower net interest income, partially offset by higher guarantee fees and higher amortization income from the guarantee obligation.

- Credit-related expenses and valuation losses increased by $6.0 billion as the impact of the deteriorating housing and credit markets in the second half of the year was reflected in:
  - Provisions for credit losses, which increased $2.6 billion, driven by higher reserves for loan losses;
  - Unprecedented mark-to-market losses on delinquent loans purchased out of trusts of $1.9 billion, driven by substantial declines in market prices for such loans;
  - Losses on certain credit guarantees, which increased $1.6 billion, driven by higher expectations of future default costs; and



- REO/foreclosure expenses, which increased $0.1 billion, driven by higher REO volumes.

- Losses on derivatives increased by $3.2 billion as the impact of declines in interest rates were reflected in lower market values for the derivatives portfolio. Potentially offsetting changes in the value of assets and debt were generally not recognized in earnings because of accounting rules.
- Net interest income decreased by $0.3 billion reflecting the impact of maturing short-term and long-term debt being replaced by higher cost debt.
- Guarantee fee income increased by $0.2 billion driven by strong growth in the volume of PCs and structured securities of 23%.
- Income from amortization of the Guarantee Obligation increased by $0.4 billion due to higher expected default costs as well as higher average balance of PCs and Structured Securities.
- Losses on the guarantee asset increased by $0.5 billion mainly due to higher return of investment due to an increase in gross cash flow driven by higher volume.

The net loss in the third quarter and further declines in long-term interest rates in October and November depleted capital sufficiently for management to take action by selling assets, issuing preferred stock, and reducing the common stock dividend.

Fair Value Financial Performance
Financial performance measured from a fair value perspective also suffered considerably. The fair value of net assets declined by $19.2 billion to $12.6 billion, despite $6.5 billion of new preferred stock issuances, as substantial increases in option-adjusted spreads reduced the value of mortgage assets, and weakening in the housing and credit markets increased expectations of future default costs. The fair value of net assets attributable to common stockholders declined by $25.7 billion to $0.3 billion.

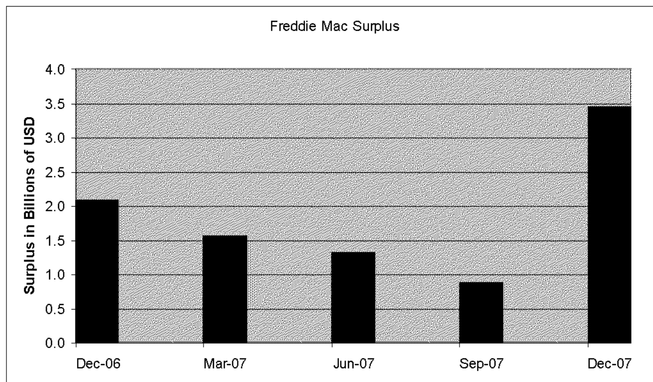
CAPITAL

OFHEO's Office of Capital Supervision formally classifies capital adequacy quarterly in accordance with Subtitle B of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and with the requirements set forth in OFHEO's minimum and risk-based capital regulations. The Enterprise is required by Federal Statute to meet both minimum and risk-based capital standards to be classified as adequately capitalized. Freddie Mac remains subject to an OFHEO-directed capital requirement imposed by a letter dated January 28, 2004.

OFHEO classified Freddie Mac as adequately capitalized for year-end 2006 and all four quarters of 2007. Since the year-end 2006 classification, Freddie Mac's capital classification was consistent with publicly released financial statements by the Enterprise, representing continued progress in becoming a timely and accurate financial reporting company. The capital classifications, unlike those cited in the 2006 Report of Examination, are no longer based upon estimates provided by management but publicly certified financial statements. While OFHEO classified Freddie Mac as adequately

capitalized during these periods and recognizes the financial reporting progress made, the Enterprise has not yet achieved registration status with the SEC. Further, risk to capital has increased dramatically primarily because of market and credit risks, which directly impacted capital through reduced current and future earnings.

Based upon restated results in early 2008, Freddie Mac's surplus as a percent of the OFHEO-directed requirement significantly declined from $2.1 billion, or 6.2 percent, for the fourth quarter 2006 to $0.9 billion or 2.1 percent for the third quarter 2007. The surplus continued to decline through October and November, with Freddie Mac failing to meet the OFHEO-directed requirement by approximately $1.9 billion on November 30, 2007, prior to year-end 2007 accounting adjustments. Freddie Mac took action to return to capital compliance by issuing $6 billion in preferred stock in early December 2007. Further erosion of capital in December resulted in a year-end 2007 surplus of $3.5 billion or 10.3 percent. While the decline in capital surplus was primarily the result of dramatically higher credit loss provisioning and continued market volatility, especially in the latter part of the year, during the first part of the year negative earnings, continued dividend payments, and growth in MBS contributed to declines in the surplus. Freddie Mac's emergency and expensive corrective action in the fourth quarter emphasizes the need for more permanently heighted attention to income forecasting, and more prudent capital management generally. In retrospect, Freddie Mac's common stock buyback and dividend increase were mistimed.



The chart to the left shows Freddie Mac's surplus over the OFHEO-directed requirement over the last five quarters. Projected credit losses coupled with low earnings could result in increased pressure on the capital base well into 2008. Specifically, the $6 billion preferred stock offering in December 2007 may be insufficient to maintain capital at ongoing prudent levels. Fair value measures of equity also have shown marked deterioration over this same time period. OFHEO does, however, expect that actions taken in late 2007, including efforts to improve capital forecasting and management, confirm Freddie Mac's commitment to maintaining capital surpluses above all capital requirements. Recent changes in accounting methods and policy will also serve to provide some short-term capital relief, but with uncertain longer-term earnings and capital consequences.

Improvements in the Capital Plan were noted during 2007, including the inclusion of economic capital positions and the articulation of Freddie Mac's capital management strategy, metrics, and assumptions. While the unprecedented financial and housing market conditions were not predictable in the market as a whole, more prudent standards for income forecasting, coupled with enhanced credit and additional market stress

scenarios, must become an Enterprise priority given the potential need to take additional actions to maintain capital at sufficient levels. Additionally, it remains essential that the capital plan incorporate fair value of equity and the effect of interest rates and volatility on AOCI within GAAP shareholder's equity.