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2006

OFHEO Freddie Mac Report of Annual Examination, 2006

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

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Examination Year: 2006

**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.

**Report of Examination
Federal Home Loan Mortgage Corporation**

EXAMINATION AUTHORITY AND SCOPE

Examination Authority and Reporting Convention

This Report of Examination contains the results and conclusions of OFHEO's 2006 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.

2006 Examination Scope

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

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. An Enterprise that is in significant non-compliance with laws and regulations may also be accorded this rating. 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. While efforts toward improvement are underway, senior management continues to revise plans and re-engineer processes to strengthen internal controls and remediate six material weaknesses and ten significant deficiencies. Leadership from the Board and senior management is challenged as they strive to reshape the corporate culture, publish accurate and timely financial statements, implement long term sustainable processes, improve overall governance and risk management capabilities, enhance information technology controls, and stabilize the organizational structure.

Intensive efforts by the Board and management have been made to address internal control weaknesses; however, several key initiatives to remediate the control environment have not progressed as planned. Progress throughout 2006 was adversely impacted by the volume and complexity of issues, less than effective project management capabilities, and inconsistent execution in key segments of the comprehensive plan. Long term resolution of identified issues will continue to require substantial efforts on the part of Enterprise personnel. The Board and management must continue to focus on needed cultural and organizational improvements identified in the internally prepared root cause analysis to ensure historically weak operating practices are strengthened. Improvements to systems capabilities, information processing controls, and the successful implementation of re-engineered business processes will be necessary to restore the overall control environment to a satisfactory condition.

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The Enterprise has: (1) a qualified and active Board of Directors, (2) a senior management team committed to resolving internal controls weaknesses and returning to timely financial reporting, (3) adequate capital; (4) strong asset quality and credit risk management; (5) effective management of interest rate and liquidity risks, and (6) adequate earnings. During 2006, efforts to improve the risk management capabilities across the enterprise have commenced and the new governance structure should provide the ability to better manage risk across the organization. Earnings volatility continues and results primarily from mark-to-market gains/losses on the guarantee asset and the elimination of hedge accounting for financial derivatives. Longer term earnings prospects may be adversely impacted by declining net interest margins and competitive pressures. Structural and economic issues in the mortgage markets heighten the importance of continuously refining economic capital measures to better quantify risks and assess financial performance returns.

MATTERS REQUIRING BOARD ATTENTION

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

- **Internal Controls.** The Board should continue to oversee management's progress toward remediating widespread 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.
- **Information Technology.** The Board should ensure that technology related issues identified in this report are addressed. Key challenges include gaining a deeper understanding of the key application controls, improving general controls, implementing a systems development process, improving contingency planning and developing a sustainable data and architecture strategy.
- **Credit Risk Management.** Continued close monitoring of credit portfolio trends is necessary as higher volumes of non-traditional credit products were purchased during 2006. Although these credit products are within current limits, these products exhibit higher than historical credit risk.
- **Corporate-wide Change Management.** The Board should continue to monitor management's efforts to: improve capabilities to effectively manage enterprise-wide change programs, gain a more in-depth understanding of the complexity and resolution strategies of control weaknesses, and support an environment that values strong internal controls and risk management functions.
- **Risk Oversight Functions.** The Enterprise Risk Management functions and the Internal Audit department made significant strides to strengthen their respective units and define appropriate governance structures. Continued Board support during the ongoing evolution of these functions and the implementation of the risk control self assessment process will be necessary.

BOARD AND MANAGEMENT SUPERVISION

Board of Directors

The Board actively oversees the affairs of the Enterprise. Board and committee materials are satisfactory. All Board Committee charters were reviewed and amended during the year, primarily to clarify and enhance risk management and technology oversight responsibilities. Corporate and divisional policies and procedures regarding financial reporting responsibilities are in place and a Quality Assurance review for financial information presented to the Board was implemented in 2006. Leadership from the Board must continue to provide the necessary oversight to ensure

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that the remediation of the internal control weaknesses and cultural transformation initiatives are effective and that strategic priorities are clearly defined and articulated.

The number of Board and Committee meetings held during the year 2006 met or exceeded the NYSE listing standards, OFHEO's Corporate Governance Regulations and Freddie Mac's Corporate Governance Guidelines. All but 2 of Freddie Mac's directors are independent and all members of the Audit, Governance, and Compensation committees are independent as required for listed companies. Term limits and age restrictions are in effect. Of the thirteen Directors currently serving, one board member exceeded those limits; however, this member was granted a temporary extension and will leave the Board during 2007. OFHEO will continue to monitor the Enterprise's transition plans to separate the positions of Chairman and Chief Executive Officer.

Management and Human Resources

Over the past three years, virtually the entire executive management team has been replaced. This level of change was appropriate to improve corporate governance, replace under-performing employees, strengthen risk oversight functions, and foster a culture of accountability. During 2006, the new executive management team made strides to improve communication, instill a sense of accountability, and focus efforts on critical issues facing the Enterprise. Despite these efforts, the internally prepared root cause analysis and the conclusions reached during OFHEO's supervisory activities indicate further efforts are required. Management will be challenged to address:

- Improving capabilities to effectively manage enterprise wide change programs.
- Gaining a more in-depth understanding of the complexity and resolution strategies associated with control weaknesses.
- Supporting an environment that values strong internal controls and risk management functions.
- Addressing employee workloads and turnover of critical staff.

Progress in the human capital field is evidenced by the filling of all executive management positions, a reduced corporate-wide voluntary turnover rate, an improved capability to attract external hires, and a reduction in open requisition rates. The Enterprise continues to face shortages in staff expertise and efforts are underway to further develop leadership competencies at critical positions - particularly in Finance, Information Technology, Internal Audit, and Accounting Policy. Within certain segments of the Enterprise, limited numbers of subject matter experts are on hand to effectively cover simultaneous high priority initiatives and baseline projects.

Enterprise Risk Management

The Enterprise Risk Management (ERM) function has been substantially enhanced over the past year. The newly implemented governance structure should provide the necessary foundation to ensure the timely identification and communication of current and emerging risks across the Enterprise. All employees currently have a risk management component in their employee performance evaluations and management plans to provide training to foster the risk management culture across the Enterprise. Efforts to more clearly define roles and responsibilities, refine policies, and establish appropriate risk limits are also underway.

During 2007, ERM plans to further strengthen the capability of the group to independently produce risk metrics, assist in the development and implementation of an economic capital framework to consistently measure risk and performance, and further aggregate financial and non-financial risks. Concerted efforts are also planned to better integrate risk management

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activities with the planning process, implement the redesigned risk controls self assessment process, collect operational loss data, and build-out the root cause analysis capabilities.

Audit

During 2006, OFHEO did not rely on the work of internal audit. Significant progress was made during 2006 to address prior recommendations and conduct pre-implementation reviews of new systems initiatives. During 2007, internal audit management continued progress toward developing a full cycle audit plan, completing and implementing scheduled enhancements in the audit methodology, augmenting staff, and further developing a quality assurance program.

The Audit Committee actively oversees the internal audit function. The Audit Committee met 11 times during 2006. 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.

The General Auditor is qualified and independent. Since the General Auditor's arrival in April 2006, improvement opportunities for internal audit have been identified and enhancements to the internal audit function have started to materialize. The General Auditor appears to have the necessary skills and leadership abilities to effect further needed improvements.

OPERATIONS

Operational risk is high and continues to be a primary supervisory concern. Throughout 2006, Freddie Mac was not able to produce accurate and timely quarterly financial statements. All sixteen internal control related material weaknesses and significant deficiencies identified during the 2005 annual audit remain outstanding. The internal control structure remains fragmented, incomplete, and in some cases undocumented. In addition, current systems limitations did not permit an effective and reliable quarterly close process. Remediation of control weaknesses including independent testing is required (controls must be complete and documented) before management and OFHEO can opine on the effectiveness of the control structure.

The Comprehensive Plan, (the primary project to return the company to timely financial reporting, improve the control environment, and permit a return to a controls based audit), suffered during 2006 from ineffective planning and inconsistent execution. The original plan was submitted in April 2006 and continues to be revised. Aggressive time schedules, lack of independent quality assurance, inadequate management reporting, cultural issues of responsibility and accountability, and project management deficiencies contributed to insufficient progress toward achieving the Plan's overall objective. Although management and staff have worked hard to mitigate and remediate known control weaknesses, no remediation activity has been tested and verified to be effective.

The Comprehensive Plan includes remediating known control weaknesses, the end-to-end business process review, close process improvements, and information technology general control remediation. Since control weaknesses are widespread and pervasive across the Enterprise, identifying control gaps and remediating most of the known material weaknesses is linked to successful completion of the end-to-end business process (E2E) review. At the same time, process improvements are needed to achieve a timely, sustainable financial close process compliant with regulatory requirements. In addition, Information Technology General Controls (ITGC) must be operating effectively before management can rely on automated information without time consuming substantive review procedures and manual processes. The Comprehensive Plan requires continued Board and executive management involvement to ensure activities are properly sequenced, achieve plan objectives, and resolve competition for resources, especially subject matter experts.

During 2006, management and staff completed formal root cause analyses over eight events that contributed to delays producing the 2005 financial statements. They also began root cause

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analyses over project management deficiencies in 2006. These exercises are important aids to understanding cultural issues, control, and business process failures that can help to limit the risk of recurrence. Management approved permanent staffing for a root cause/problem analysis function in Operational Risk Oversight to provide an ongoing analysis capability.

Although considerable efforts are under way to remedy weaknesses in internal controls related to financial reporting, additional control weaknesses may exist elsewhere in the Enterprise. Plans to identify, assess, and strengthen certain non-financial controls are commencing. These controls may include, but are not limited to: business continuity planning, business and risk performance measures, and operating effectiveness metrics.

Information Technology

Successful resolution of a number of the material weaknesses and significant deficiencies depend on information technology remediation efforts. Weaknesses continue in information technology systems development and delivery, information security, end-user computing systems, data quality, and change management.

The establishment of reliable information technology general controls (ITGC) is necessary to establish the overall control environment. Limited progress in documenting and strengthening ITGC occurred during 2006. Late in 2006, management revised the plan to fully document and commence remediation of these controls. The ITGC project intends to document ITGC under the *Control Objectives for Information and related Technology* (COBIT) framework, verify effectiveness of controls in place, and remediate weaknesses. Under the plan, ITGC control gaps will be identified in 2006/7 with remediation extending into 2008.

The lack of an effective systems development lifecycle methodology contributed to delays with the implementation of strategic technology upgrades and replacements. Throughout 2006, issues surfaced related to implementation of automation projects designed to replace legacy technology systems, improve controls and allow for shortened time lines for the monthly close financial processes. Interim measures to improve systems implementations include the establishment of the Targeted Quality Control function in December 2006. Management plans to adopt a systems development life cycle methodology during 2007.

Weaknesses in core systems capabilities and slow replacement of legacy systems have required a heavy reliance on end-user computing (EUCs), spreadsheets, and manual processes in the financial close process. During 2006, progress was made to inventory and implement EUCs controls; however, final completion of an effective EUC control framework has been delayed and is now anticipated to be completed in 2007.

Overall data quality remains a concern. Management has begun developing data quality standards; however, some of the business plans are under development and more detailed plans suggest that efforts to bring the Enterprise into compliance with these plans are resource-intensive and may not be scalable for all areas. Also, existing point-to-point systems architecture (existing systems and data infrastructure) compounds the problem related to improving data quality. Development of a long term plan for systems architecture and improved systems development methodology controls would strengthen the remediation of data quality issues.

The current business continuity planning program does not address the critical risks of a regional disaster. While the plan focuses on systems recovery, it does not adequately address the effective relocation of people (currently concentrated at the headquarters), data, systems and records/documents required to continue business in the event of a regional business disruption.

Management has made progress with system recovery capabilities for higher risk functions through the outsourcing of the settlement and custody functions and the establishment of an out-of-region wire transfer room.

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Accounting

Management is nearing completion of its effort to codify and update its significant accounting policies. However, significant work remains to develop complete accounting policies and procedures. Completion of this project will be a necessary step to demonstrate that approved accounting policies are incorporated into automated systems and operational procedures. OFHEO continues to closely monitor the resolution of a number of simplifying accounting assumptions that are used as part of the financial reporting process. Recruiting efforts continue as the Enterprise seeks to attract additional qualified accounting expertise.

The Enterprise still faces the challenge of becoming a registrant with the SEC. Currently, the Enterprise is not subject to the reporting timeframes that would be expected of a timely filer, and therefore management must ensure that processes being developed are robust to handle this task.

In June 2006, the Enterprise issued its Information Statement and Annual Report to Stockholders for the fiscal year ended December 31, 2005. Based on the continued existence of material weaknesses at December 31, 2005, the Enterprise concluded that its internal controls over financial reporting were not effective at December 31, 2005. The external auditors' performed a substantive audit of the 2005 financial statements. The PricewaterhouseCoopers LLP report did not express an opinion on management's assessment of the effectiveness of the Enterprise's internal control over financial reporting as of December 31, 2005, nor did the PwC report express an opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2005. A substantive audit is being conducted for the 2006 audit.

MODEL RISK

Model risk governance has improved. Further efforts are necessary to upgrade governance practices for model development and enhance the quality of independent model risk oversight.

In 2006, the Enterprise approved new model-related policies that strengthened model risk oversight. A number of significant models implemented over the past decade were not developed under a consistent and controlled development process. Management's progress in harmonizing and implementing procedures and practices with the new policies should improve the repeatability and auditability of the model development process throughout the Enterprise.

Independent model risk oversight is provided through the Modeling & Methods group (M&M). M&M's authorities and scope of responsibility are now articulated in a written charter and policies. M&M is now in the process of developing standards to achieve compliance with the newly adopted charter and policies. Once implemented this group should provide meaningful independent evaluations of the quality of the business units' model development practices, the degree of adherence to corporate policy, and professional standards. Efforts have been strengthened to ensure management resolves M&M findings in a timely and complete manner. M&M must continue to assess the sufficiency of staffing and other resources to fulfill its new, more broadly defined responsibilities. Management has exhibited the willingness, and has taken steps, to address the shortcomings identified and to enhance independent model risk oversight.

ASSET QUALITY

The Enterprise's overall asset quality is strong. All portfolios currently exhibit favorable quality and performance metrics. The Enterprise prudently manages exposures to significant counterparties (e.g., seller/servicers, mortgage insurers, and derivatives counterparties) and monitors top seller/servicer and mortgage insurer concentrations.

There are no immediate signs of significant deterioration in credit performance trends; however, expected default costs are increasing. Over the past several years, significant shifts in the nature

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of mortgage originations and the composition of the retained portfolio have occurred as the market continues to produce mortgages with higher risk profiles. As the portfolio seasons, adverse changes in house price appreciation, mortgage rates, or unemployment levels could negatively impact future performance.

During 2006, the governance structure improved significantly with the creation of the Governance, Nominating and Risk Oversight Committee, the Enterprise Risk Management Committee and the Credit Risk Subcommittee along with Board-approved credit policy and limits, and the delineation of roles, responsibilities, and authorities for Credit Risk Oversight and for business line functions.

Underwriting standards and credit administration practices are prudent, although opportunities for improvement were identified. Line management and Enterprise Risk Management are in the process of addressing recommendations related to the enhancement of: business line credit policy and procedure development and implementation, data collection and reporting improvements, staffing issues, and segregation of duties.

The Enterprise has made concerted efforts to comply with OFHEO's 2005 Mortgage Fraud Reporting Regulation and related policy guidance. Recommendations to augment several processes contained in the policy guidance include reporting of loan-level repurchases, prompt submission of the Mortgage Fraud Information Notice (MFIN), reporting of supplemental or corrected MFINs, and internal controls and procedures.

Single-Family Business

Management has expanded the Enterprise's purchase and guarantee of higher-risk mortgages. In order to increase market share, meet mission goals, stay competitive, and be responsive to sellers' needs, the Enterprise has increased the use of credit policy waivers and exceptions. Untested and alternative market products accounted for approximately 24% of 2006 new purchases and currently comprise 11% of the total single family mortgage portfolio. Internal measures of credit quality reflect that the quality of incremental new purchases declined in 2006 as evidenced by an expected rise in default costs.

Current portfolio performance metrics reflect a low level of serious delinquencies and credit losses. Serious delinquencies remain low. The average mark-to-market loan-to-value is estimated at 56%. 2006 net credit losses totaled \$203 million v \$141 million at year-end 2005. The largest segment of net credit losses is attributable to economic conditions in the north central region. Hurricane Katrina losses continue to be low.

The Enterprise is in the process of updating its Single-Family credit policy to reflect the current credit risk appetite and corresponding strategies, and the Credit Risk Oversight group has increased its attention to credit policy waivers and exceptions.

Multifamily Business

The Multifamily credit portfolio remains sound. With improvements in vacancy levels and rent growth, the market was strong throughout 2006. The Multifamily bond equivalent rating for 2005 and for September 2006 year-to-date purchases was A- versus a 2006 full-year target of BBB+.

Year-over-year, November 2006 delinquencies were down and were reported at .01% versus .06%. The average mark-to-market debt-coverage ratio was 1.62 versus 1.61 for 2005, and only 15.7% of the portfolio has a mark-to-market debt coverage ratio <1.15 versus 16.1% of the portfolio for 2005. The High and Critical Watchlists have declined from \$545 million as of September 2005 to \$293 million as of September 2006. September 2006 net credit losses totaled \$3.6 million -- .64 bps of the active Multifamily UPB.

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Liquidity and Contingency Portfolios

At December 31, 2006, the credit quality of the total Liquidity and Contingency Portfolio assets contained ratings of AAA (50%), AA (33%), and A (17%), exhibiting the high credit quality necessary in a liquidity portfolio. Credit quality of Marketable Securities in the Liquidity & Contingency Portfolio remained consistently strong with more than 99% of the asset-backed securities at AAA and less than 1% rated A.

Investment Portfolios

During 2006, the composition of the retained mortgage portfolio (excluding the liquidity portfolio) was stable, with agency products representing approximately 65% total Unpaid Principal Balance (UPB) and non-agency products representing 35%. Through June, the UPB of the agency securities portfolios grew by approximately 2% and non-agency securities grew by approximately 4%. This contrasts with 2005 when the non-agency securities portfolio grew by 38% for the year.

As of July 1, 2006 the Enterprise initiated a voluntary commitment to limit the growth of the retained mortgage portfolio to 2% annually on a GAAP basis. During the second half of 2006, the market tightened and the Enterprise reduced the retained mortgage portfolio to protect against the possibility of market value gains that could result in GAAP growth in excess of the 2% annual limitation. The agency securities portfolios declined by approximately 6% and the non-agency securities portfolios declined by approximately 4.5%.

During 2006, net purchases of non-agency floating rate securities outweighed net purchases of non-agency and agency fixed rate and agency floating rate securities. Non-agency floating rate securities experienced significantly faster prepayment speeds relative to other securities. The Enterprise purchased higher volumes of non-agency floating rate securities because of their positive impact on affordable housing goals and risk/return profile.

As of September 30, 2006, roughly 99% of the mortgage asset backed portfolio was rated AAA, and 98% was internally rated as having either excellent or good coverage for current delinquencies.

Enterprise Counterparties

Credit Risk Oversight provides ample oversight of aggregate counterparty risks and exposures at the Enterprise level for all counterparties and maintains a Counterparty Watch List. All three business lines – Single-Family, Multifamily and Investments and Capital Markets – manage their counterparties with a particular focus on each business line's top counterparties. Single-Family's top ten largest exposure holders (by family) represent 69% of the business' total exposures. Multifamily top ten customers (seller/servicers) represent approximately 69% of the business' portfolio UPB with the top customer representing 19% of portfolio UPB. Top ten borrowers represent 14% of portfolio UPB with the top borrower representing 4% of portfolio UPB. At the business level, Investments and Capital Markets represents roughly 81% of the Enterprise's counterparty exposures while Single-Family represents 17% and Multifamily represents 1%. For Investments and Capital Markets, fed funds represent the largest counterparty exposure.

LIQUIDITY

Management adheres to sound practices for managing liquidity. The Enterprise is not vulnerable to funding difficulties at this time, and earnings and capital exposure from the liquidity risk profile is low. The Enterprise has access to sufficient sources of funds to meet present and anticipated liquidity needs.

Management is able to effectively forecast liquidity needs and sources; and to identify, measure, monitor, and control the Enterprise's liquidity position. Management has enhanced liquidity management practices during 2006 to better forecast short and long-term liquidity needs.

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Liquidity management policies and procedures are being revised to support the enhanced processes. A satisfactory liquidity contingency plan is in place. Management has consistently maintained its liquidity and contingency portfolio at a prudent level, consistent with policy and OFHEO regulations. Risk limits are in place to ensure sufficient liquidity levels, and an independent risk oversight group evaluates limits, exposures, and pertinent metrics on a daily, weekly, and monthly basis. Management conducts liquidity event testing on a periodic basis, and the results indicate that the Enterprise should be able to withstand severe liquidity events.

Impact of Fed Overdraft Policy Change

During the second quarter 2006, the short-term investment portfolios in the Liquidity & Contingency Portfolio, the Working Capital and the Money Market portfolios, increased approximately \$30 billion due to efforts beginning in May to increase short-term investments as they planned for the July 20, 2006 Federal Reserve's Payment System Risk Policy change. The second half of 2006 saw the reduction of the \$30 billion in short-term investments as the Enterprise gained greater efficiency in managing its daily cash position. The temporary growth of the low risk short-term investments was a prudent step in ensuring Freddie Mac's ability to comply with the July Fed overdraft policy change.

SENSITIVITY TO MARKET RISK

Overall interest rate risk exposures are acceptable and management is effective. During 2006, Enterprise management was able to identify, measure, monitor, and control the sensitivity to market risk in a manner commensurate with the nature and complexity of the Enterprise's activities. Measures of rate sensitivity gauge the degree to which changes in interest rates can adversely affect the Enterprise's earnings and fair value.

Given the nature of the Enterprise's business, fair value and earnings are highly sensitive to changes in rates and spreads. The Enterprise relies primarily on financial derivatives (in conjunction with callable debt) to maintain interest rate risk exposures within desired ranges. Financial derivatives instruments are highly-sensitive to changes in rates and that volatility is reflected in their financial statements because hedges are mark-to-market through income and most assets and liabilities are not. Sensitivity analyses and stress testing indicate that the Enterprise's market value of equity is adequately protected against sudden significant changes in rates and in spreads between certain rates.

Board-approved asset/liability management (ALM) policies and limits are designed to ensure that management maintains interest rate risk exposures within prudent boundaries and avoids the need to engage in large rebalancing activity. The Board revisits these policies and limits at least annually, and several senior management committees and subcommittees - as well as an independent market risk oversight (MRO) group -exercise ongoing oversight and monitoring of Enterprise exposures relative to established limits and thresholds. In addition, two Board committees monitor the Enterprise's results against approved limits and performance objectives. Decision-making authority is formally delegated and effectively communicated within the organization at least annually. Risk measurement is performed both in-house and through an outside service provider (BlackRock Solutions). Management reports provide the information necessary to inform and support decision-making at appropriate levels of the organization.

Publicly-reported measures of interest rate risk—Portfolio Market Value Sensitivity (PMVS-Level and PMVS-Yield Curve) and duration gap—reflect that management kept exposures stable and within applicable limits and operating thresholds throughout 2006. PMVS expresses the degree to which market value of equity is impacted by adverse parallel (50 basis point) and non-parallel shifts (12.5 basis point shifts at the 2-year and 10-year points on the LIBOR curve). Additional, nonpublic, quantitative measures of interest rate risk, including convexity, vega, key rate duration, and basis risk exposure, reflect that management maintained exposures within applicable internal limits/thresholds as well.

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In January 2006, OFHEO issued a letter requiring a divestiture plan for certain Commercial Mortgage Backed Securities structures that were not allowed under the Enterprise's charter; management has completed the sale of those securities. Management also remediated several matters pertaining to investments in non-Agency home equity Asset Backed Securities floaters. In addition, the Board and management oversight of a variety of issues pertaining to the Asset/Liability Management group's position taking on levels of rates, spreads, and volatility reported internally under Return on Interest Risk Positions has been augmented. The significant and volatile impact these activities have on fair value continue to warrant appropriate scrutiny to ensure that the related activities are properly authorized, measured, monitored/reported, and subject to appropriate limits. The enterprise has committed to reviewing and enhancing its public disclosures to adequately describe the risk taking activities which are currently grouped and reported within its ALM and hedging functions.

EARNINGS

Preliminary financial results for 2006 are un-audited. The most recent publicly-disclosed audited financial statements are for the year ended December 31, 2005.

Based on un-audited results, earnings performance for 2006 is fair. GAAP net income during the period 2002 to 2005 ranged from a high of \$10.1 billion to a low of \$2.1 billion reflecting a steady downward trend since 2002. A similar negative trend is exhibited in the change in fair value of common equity before capital transactions over the same period declining from \$5.6 billion in 2002 to \$1.0 billion in 2005. In 2006, net income increased to \$2.2 billion from \$2.1 billion in 2005.

Preliminary earnings have been volatile as a result of mark-to-market gains/losses on the guarantee asset and the derivatives portfolio. Declining interest rates caused mark-to-market losses on both the guarantee asset and the derivatives portfolio during the second half of 2006. The Enterprise reported a net loss of approximately \$0.7 billion for the third quarter of 2006, a development which generated a supervisory response from OFHEO. The Enterprise also internally reported a net loss of \$0.5 billion in 4Q06.

Long-term declines in earnings are due to a number of factors, some of which are recurring and are likely to have a dampening effect on future earnings. Competitive pressures along with declining net interest margin will likely impact future earnings. A flattening yield curve, increased competition for mortgages, and the re-funding of lower coupon fixed rate debt that either matured, was called or re-purchased, contributed to the downward pressure on net interest margin in 2006. Since 2004, the net interest margin has declined by about 60 basis points, to 0.57 percent in the fourth quarter of 2006. Freddie Mac expects the net interest margin to continue declining in 2007 as lower cost debt matures. Administrative expenses of approximately \$1.6 billion were slightly higher than in 2005.

The core guarantee business continues to provide sources of significant recurring earnings; however, significant sources of revenue are concentrated in several mortgage lenders. Guarantee fee income increased by \$0.2 billion in 2006. Guarantee fee growth was supported by an annual increase in outstanding participation certificates of 15.2 percent.

The loan loss reserve decreased during 2006 from \$447 million to \$420 million.

CAPITAL

OFHEO classified Freddie Mac as adequately capitalized for the first three quarters of 2006. 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. The Enterprise is adequately

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capitalized and maintains satisfactory cushions above statutory, regulatory, and internally-mandated capital levels. OFHEO continues to evaluate and monitor the capital surplus, in part due to the evidence of significant operational risk and control weaknesses cited throughout this report. Capital planning processes are satisfactory and assess risks throughout the company, although methods of measurement and analysis can be enhanced.

OFHEO imposed a capital surcharge of 30 percent of the minimum capital surplus in January 2004 due to increased operational risk. OFHEO also concurred with the Enterprise's decision to limit retained mortgage portfolio growth as recommended by OFHEO, further enhancing the capital adequacy of Freddie Mac. During 2006, OFHEO emphasized the importance of maintaining a capital surplus in excess of the OFHEO-directed requirement given the lack of timely financial filing and the continued operational weaknesses. The Enterprise has maintained the surplus above the OFHEO-directed requirement since inception of the agreement. The Enterprise has also remained in compliance with the mortgage portfolio limits and appropriately incorporates these restrictions into its capital plan.

On December 28, 2006, OFHEO announced that it had classified Freddie Mac as adequately capitalized as of September 30, 2006. As of that date, the core capital of the Enterprise exceeded its OFHEO-directed capital requirement by \$3.076 billion, representing a 9.1 percent surplus over the OFHEO-directed capital requirement and a 41.8 percent surplus over the statutory minimum capital requirement. OFHEO classified Freddie Mac as adequately capitalized for the preceding two quarters of 2006, and will not issue the December 31, 2006 classification until March, 2007. Freddie Mac's capital plan describes how the Enterprise expects to maintain a surplus over the OFHEO-directed capital requirement through a combination of controlled growth and earnings retention.

During 2006, the Enterprise has continued to enhance and refine its capital planning processes and produced an acceptable capital plan on a quarterly basis. OFHEO communicated a need for enhancements to the capital plan and management incorporated these enhancements appropriately and timely. Weekly management reports, which include current and projected capital trends and actions, provide senior management with effective tools to manage the capital position above OFHEO-directed requirements.

OFHEO's capital classification is based on Freddie Mac's best estimate of its financial condition, as certified and represented as true and correct by Freddie Mac's management. The capital classifications for 2006 are subject to revision pending completion of the 2006 financial statements and related audit processes. In particular, as a result of GAAP requirements to book subsequent events in the earliest prior open quarter, the Enterprise has informed OFHEO that net income will be revised for Q1 through Q3 in the order of hundreds of millions.

CONSENT ORDER

The Enterprise is in satisfactory compliance with the Consent Order dated December 9, 2003. One provision that remains open is the separation of the CEO and Chairman of the Board positions. Senior management submitted a two-year transition plan to OFHEO in late 2006 which addresses this matter. OFHEO continues to monitor management's progress in key areas highlighted by the Consent Order, including strengthening internal controls, developing a risk management oversight program, improving the internal accounting function, augmenting the internal audit program and striving to make positive changes to the corporate culture.

September 2005 Agreement

Freddie Mac is subject to a September 2005 agreement with OFHEO on matters pertaining to subordinated debt, public disclosure, and liquidity management. As of December 31, 2006, Freddie Mac was in compliance with 12 of the 13 requirements of the agreement. Freddie Mac has not publicly disclosed certain metrics for credit risk, as required by the agreement. In January 2007, the appropriate credit risk disclosures were made.