

Examination Year: 2005

Federal Home Loan Mortgage Corporation
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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.

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EXAMINATION AUTHORITY AND SCOPE

Examination Authority and Reporting Convention

This Report of Examination contains the results and conclusions of OFHEO's 2005 annual examination of the Federal Home Loan Mortgage Corporation ("Freddie Mac" or the "Enterprise") performed under section 1317(a) of the Federal Housing Enterprises 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 "CAMELS" methodology (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) similar to those adopted by the federal depository institution regulators to report examination results and conclusions to the Board of Directors and to Congress.

2005 Examination Scope

Our examination activities focused on supervision provided by Board of Directors and senior management, 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.

EXAMINATION CONCLUSIONS

The Enterprise remains a supervisory concern, although efforts toward improvement are underway. The Board and management are continuing to revise and implement comprehensive plans to strengthen senior management, improve controls, and balance priorities, initiatives, and risks. Leadership from the Board and senior management will be challenged during 2006 to reshape the corporate culture, build long term sustainable processes, further improve overall governance, enhance risk management capabilities, stabilize the organizational structure, reduce turnover, and clarify responsibilities.

While concerted efforts by the Board and management have been made to address the myriad of concerns, progress during the second half of 2005 was slowed as the volume and complexity of issues became more apparent. The Enterprise continues to experience a number of significant operational issues, high turnover, and weaknesses in entity and process level internal controls. During 2005, efforts to implement sustainable processes to permit the issuance of timely and accurate financial statements were less than fully effective. Although necessary, the high level of business and process change throughout the organization has stressed the existing infrastructure, risk management systems, and operating practices. Long term resolution of identified issues will require substantial efforts on the part of Enterprise personnel. 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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While the resolution of internal controls remains an on-going concern, the Enterprise has: (1) a qualified and active Board of Directors, (2) a senior management team committed to resolving weaknesses, (3) a significant capital surplus; (4) strong asset quality, (5) and effective management of interest rate and liquidity risks. During 2005, the Enterprise has developed an integrated multi-year business plan that recognizes the need to improve accounting and financial management capabilities, enhance operating controls, and enhance risk management activities.

MATTERS REQUIRING BOARD ATTENTION

Key matters highlighted in this report requiring strong Board oversight:

- ***Human Resources.*** The Board should closely monitor key human resource metrics such as staffing levels, turnover statistics and open requisitions to ensure day-to-day activities are appropriately staffed and effectively managed. The Board should also continue to monitor key cultural initiatives related to building a strong executive team, strengthening management depth and expertise, and ensuring staffing levels are consistent with Enterprise priorities.
- ***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. Strengthening and improving internal controls for financial, managerial and regulatory reporting processes along with the planned changes in enterprise risk management, data processing, and operational practices are necessary. Effectively managing the pace of introducing new products and services deserves continued attention to balance resource requirements with other important control initiatives.
- ***Enterprise Risk Management.*** The Board should track management's progress in establishing an effective Enterprise risk management program to ensure authorities, roles, and responsibilities are clearly defined and Enterprise level risks are promptly identified, aggregated, and reported. Improvements in business line risk management practices, the risk control self assessment process, achieving compliance with corporate policy, and consistent establishment and monitoring of risk limits are also necessary.

BOARD AND MANAGEMENT SUPERVISION

Board of Directors

The Board actively oversees the affairs of the Enterprise. The quality of Board reporting has improved since 2004. Board and related committees are provided sufficient and timely information to make informed decisions. Continued leadership from the Board

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will be necessary to ensure ongoing unity among the new senior management group, clarity of priorities, and strategic direction.

The number of Board and Committee meetings held during the year 2005 met or exceeded the NYSE listing standards, OFHEO's Corporate Governance Regulations, and Freddie Mac's own Corporate Governance Guidelines. The majority 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 being enforced. Of the thirteen Directors currently serving, two of the original Board members remain. OFHEO will continue to monitor the Enterprise's previous commitment to separate the positions of Chairman and Chief Executive Office.

Human Resources

High levels of organizational change, adverse press, legislative uncertainty, a redefining of the corporate culture, changing priorities, and tight job market in the financial services sector continue to affect the Enterprise's ability to attract and retain qualified staff. Changes in senior management along with a number of initiatives are designed to improve leadership capabilities, increase management depth, and address short and long-term cultural issues.

Record levels of employee turnover in 2005 were a key factor influencing operational risks and the ability to fully achieve corporate goals and objectives. Turnover in 2005 more than doubled from 2004 and occurred at all levels within the Enterprise. Since 2004, the Enterprise has replaced virtually all members of senior management – over two dozen positions. Several key positions remain open and are in the process of being filled. Voluntary turnover accounted for nearly 75% of the run-off in 2005 and was highest among employees with between 1 and 4 years of tenure and among manager-level employees. High annualized 2005 turnover rates were in critical areas such as Finance, Investment & Capital Markets, and Internal Audit. Some areas have experienced turnover at rates greater than 30%. Requisitions to fill open positions climbed each quarter.

Year-end Staff Turnover and Open Requisition Statistics				
	2005		2004	
	Rate	Total # of Positions	Rate	Total # of Positions
Annualized Employee Turnover	19%	962	8%	416
Open Requisitions	10%	543	7%	389

Enterprise Risk Management

The Enterprise Risk Oversight (ERO) function is not fully effective. The current ERO model focuses on credit, market, model, and operational risk. The existing framework lacks sufficient clarity with respect to authorities, roles, and responsibilities. Resource limitations and the current governance structure limited ERO's ability to identify,

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aggregate, and report current and emerging risks across the Enterprise. Instances have been noted in which ERO recommendations are not promptly addressed by management. The implementation of an effective risk management program will also require improvements in line-of-business risk management capabilities through the risk control self assessment process, ongoing compliance with corporate policy, and the adoption of enhanced processes to establish, change, and monitor various limits/exposures.

The Enterprise Risk Management governance structure is being re-assessed under a new leadership team to address the examples noted above and improve the effectiveness of the function. The enhanced risk management framework will integrate corporate-wide financial and non-financial related risks; clarify roles, responsibilities, and authorities; and integrate reporting of risks across the Enterprise. The evolving risk management framework should improve coordination and integrated reporting among enterprise risk management, audit, legal, and compliance.

Audit

The Audit Committee of the Board met sixteen times during 2005 and actively oversees the internal and external audit programs. The General Auditor and external auditors have sufficient interaction with the Audit Committee including periodic executive sessions.

During 2005, OFHEO did not rely on the work of Internal Audit to support examination activities since a substantial portion of the traditional audit program was accomplished during the latter part of 2005 and early 2006. Traditional audit activities were delayed until late 2005 as Internal Audit was involved in testing key controls. Internal Audit has now returned to a regular audit schedule.

Internal Audit's planning methodology currently requires improvement to reach the standard expected of a large, complex financial institution. Areas to improve include: developing a more formal systematic evaluation to identify the audit universe, updating policies, and improving the rationale for the audit plan. Staffing vacancies and turnover continue to be challenges for the division.

Compliance

The corporate compliance management function was established in late 2003 and is responsible, in part, for maintaining acceptable programs to ensure ongoing compliance with applicable laws, rules, and regulations. In addition, the division also maintains and provides employee training on ethics and the corporate code of conduct. As noted above, efforts are underway to ensure that compliance risks are more fully integrated into the evolving enterprise risk management function. The Chief Compliance Officer has sufficient interaction with the Audit Committee including periodic executive sessions.

Internal Controls

Internal controls surrounding financial, managerial, and regulatory reporting processes are weak. Fundamental changes in enterprise risk management, data processing, and operational controls are necessary before the Enterprise can easily self-identify and remediate widespread control weaknesses. While the Finance division has been

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responsible for overseeing internal control remediation efforts, responsibility for full resolution rests with management of the business units. Freddie Mac staff continues to aggressively address and remediate or mitigate all known material and significant control deficiencies, but the number of known material weaknesses and significant deficiencies remains high. Progress developing sustainable processes to mitigate and remediate entity and process level control weaknesses has been slow and not completely effective. Considerable work remains before the Enterprise can achieve a timely and consistent financial close process, return to controls based auditing, and release audited financial statements on a regular schedule that is compliant with regulatory requirements.

Internal control testing continues to show high error rates. The high error rates reflect a need to properly define and design effective end-to-end key control processes. During 2005, management discovered errors that internal controls did not prevent or detect in a timely manner. Additional errors are likely to surface as keys controls are validated and tested, application systems are upgraded or replaced, and standardized account reconciliation processes are implemented. Weaknesses in change control, testing and analytics increase risk that errors in financial reporting will not be detected in a timely fashion. For example, the effectiveness of detective monitoring and analytic controls, including account reconciliations, are hampered by a cumbersome General Ledger and lack of detailed subsidiary accounting records. Full control remediation may not be possible until Freddie Mac implements improved automated systems and operating controls around the Enterprise – in front office locations, operations units, and in financial accounting.

Accounting policy codification and development requires improvement. While progress has been achieved, additional efforts are underway to communicate and finalize the codification of all existing accounting policies, incorporate new accounting literature, and assure that accounting policies align with internal control documentation and new product introduction.

To help achieve internal control effectiveness and increased reliance on controls, management is now preparing a plan to complete a comprehensive end-to-end analysis of the company's design of financial controls. Throughout 2006, management intends for this analysis to identify control gaps and ensure the effectiveness of key financial controls.

A number of factors contributed to slow progress in 2005 in improving financial control effectiveness:

- The planning/sizing of efforts needed to resolve problems was inadequate. Business units designed plans and tasks to meet aggressive deadlines instead of developing sustainable and adequate processes to address control deficiencies.
- Use of the “silo” approach (by business area) to control design, documentation, and remediation efforts did not effectively address the risk that controls would not operate effectively across business units or in aggregate.

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- High staff turnover complicated all initiatives and threatened the effective execution of the many manual controls relied on by the company.
- The importance and need to document and test IT General and IT application controls was recognized late.
- There were a number of simultaneous high priority initiatives, all demanding time and attention from key subject matter experts, including:
 - A high volume of new products
 - Automation improvements
 - Internal control design, documentation, and testing activities
 - Control weaknesses mitigation and remediation activities
 - Analyzing and re-testing internal control weaknesses as errors were identified
 - Shortening monthly processing deadlines to meet timely reporting objectives

A number of risks to successfully remediating internal control weaknesses remain and include:

- Lack of a comprehensive plan and end-to-end analysis of financial controls.
- Weakness in the risk control self-assessment process.
- Complexity associated with the interdependent nature of the remediation activities.
- Uncertainty regarding the quality and sustainability of newly established controls and interim controls.
- Layers of additional manual and/or detective controls that may not effectively compensate for inadequate controls over automated processes.
- High turnover levels and depth of subject matter experts.
- The continued discovery of control testing failures including previous identified weaknesses.
- Existing control deficiencies, if not addressed, may develop into material weaknesses.
- The number of existing simplifying assumptions.
- Controls remediation work is focused on controls related to financial reporting and not on other non-financial statement related controls.
- A need to provide ongoing employee training programs related to internal controls and responsibilities.

Model Risk

Model risk governance requires improvement. Improvements are necessary to upgrade governance practices for model development and to control and enhance the quality of independent model risk oversight.

In 2005, the Enterprise reorganized and unified model development activity within the Risk Measurement and Capital Strategy group of the Investment and Capital Markets (I&CM) division. I&CM management is in process of working through the challenges

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inherent in a substantial corporate reorganization. Management is harmonizing model-related policies, procedures, and practices to improve the repeatability and auditability of the model development process. Model risk governance is an evolving discipline, and professional and regulatory standards are becoming more demanding.

The practices of the independent model risk oversight function housed within the Enterprise Risk Oversight division—the Modeling & Methods group (M&M)—require improvement if the group is to provide meaningful, independent evaluations of the quality of the business units model development practices and degree of adherence to corporate policy and professional standards. M&M’s authorities and scope of responsibility should be clearly articulated in the form of a written charter; policies, procedures, and practices should be enhanced to ensure management resolves findings in a timely and complete manner; and M&M should be allocated sufficient staffing and other resources to fulfill its defined responsibilities. Management has exhibited a willingness and has taken steps to address the shortcomings we have identified and to enhance independent model risk oversight.

ASSET QUALITY

The Enterprise’s overall asset quality is strong. The single-family, multifamily, investment securities and liquidity and contingency portfolios currently exhibit favorable quality and performance metrics. There are no immediate signs of significant deterioration in credit performance trends. Over the past several years, significant shifts in the nature of mortgage originations and the composition of the retained portfolio have occurred. As the portfolio seasons, adverse changes in house price appreciation, mortgage rates, or unemployment levels could negatively impact future performance. In general, underwriting standards and credit administration practices are prudent, although we have identified several opportunities for improvement given the Enterprise’s expansion of investment and guarantee activities in the subprime and nontraditional mortgage sectors. The Enterprise prudently manages exposures to significant counterparties (e.g., seller/servicers, mortgage insurers, and derivatives counterparties).

At times, credit policy development and implementation lag behind related business activities. Credit policies do not consistently define risk tolerances, responsibilities and accountabilities. In some instances credit-related processes are not consistent with the Enterprise’s corresponding policies and procedures. The internal control framework requires continued review and re-assessment as the Enterprise pursues new business activities and market share objectives.

Single-Family Mortgage Portfolio

Current portfolio performance metrics for the single-family mortgage portfolio reflect a low level of serious delinquencies and credit losses. Credit losses in 2005 (charge offs and REO expense) were \$141 million, unchanged from 2004. Management projects credit losses will increase modestly during 2006 due to hurricanes Katrina and Rita, seasoning of the existing book, and softening house prices. As noted above, shifts in the nature of mortgage originations (e.g., the dramatic increase in hybrid Option ARMs and

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affordability products with no historical performance data), have changed the composition of the mortgage portfolio over the past few years. Unfavorable housing price trends, increasing unemployment levels, and/or increasing mortgage rates could alter future portfolio performance.

Management has expanded the Enterprise's purchase and guarantee of higher-risk mortgages. Internal measures of credit quality reflect the quality of the Enterprise's incremental purchases declined in 2005. For example, expected default costs (a measure of inherent risk exposures in the portfolio) on new purchases increased sharply during the 4Q05. Similarly, internal measures of credit risk reflect that the percent of single-family flow purchases in the A/A+ risk class declined moderately in 2005, from 89-92 percent in 2004 to 85-88 percent in 2005.

The Enterprise has not yet developed the requisite credit quality assessment tools and operational capabilities to support a significant expansion into the subprime and nontraditional sectors. Consequently, the Enterprise is in the process of strengthening the credit risk management framework necessary to enable the Enterprise to properly identify, measure, monitor, and control the credit and operational risks inherent in subprime and non-traditional mortgage portfolios and related activities.

The volume of new product introduction has outpaced the supporting infrastructure and has required management to approve new product offerings with high exception (conditions) levels. Clearly, management faces a difficult and complex challenge to support new mortgage products at the same time they are in the process of remediating a considerable array of significant deficiencies and material weaknesses in internal controls. The Enterprise is in the process of enhancing its practices for developing and introducing new single-family mortgage products. As part of this effort, senior management has begun to prioritize and rationalize new product introduction to ensure satisfactory infrastructure and governance practices are in place.

Multifamily Loan Portfolio

The multi-family credit portfolio remains sound. Multifamily mortgage portfolio growth was modest during 2005. The strong credit performance can be partially attributed to rising interest rates which have resulted in declining vacancy rates and increasing rentals. In addition, relatively soft multifamily rental markets in the Southeast have benefited from the effects of Hurricanes Katrina and Rita.

Portfolio credit losses continue to be close to zero with no delinquencies sixty days or greater. Losses due to the effects of Katrina and Rita are minimal, with loss projections at, or less than \$18 million. REO asset management remains strong with inventories continuing to decline. During 2006, management is developing a fully integrated costing and risk rating system for the multi-family portfolio.

Investment Securities

The nonagency mortgage asset-backed securities portfolio remains the most rapidly-expanding segment of the Enterprise's retained portfolio. The unpaid principal balance

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of this portfolio grew 38 percent in 2005 (from \$175 billion to \$243 billion), and at year-end comprised over 30 percent of the retained portfolio and 6 times core capital. This portfolio grew significantly—53 percent—in 2004 as well. Although a vast majority all of the securities in the portfolio are AAA-rated, the Enterprise's credit risk management practices governing this portfolio segment require improvement. The most notable improvements are required in credit administration and operations, including clarifying investment strategies and portfolio limit-setting, improving credit policy development, credit assessment tools, risk reporting, and operational capabilities.

During our examination of risk management practices governing the Enterprise's commercial mortgage-backed securities (CMBS) portfolio, OFHEO in consultation with the Department of Housing and Urban Development determined that certain security structures involving cash flows from mixed pools (i.e., pools containing both multifamily properties and non-residential commercial properties) were not authorized under the Federal Home Loan Mortgage Corporation Act. As a consequence, OFHEO directed the Enterprise to submit a written plan that provided for the timely and orderly divestiture of the unauthorized securities. Management submitted an acceptable plan that will result in the liquidation of the unauthorized securities by year-end 2006.

LIQUIDITY

Liquidity is strong. The Enterprise has access to sufficient sources of funds on acceptable terms 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. Liquidity management policies, procedures, and a liquidity contingency plan are in place and identify authorized investments, exposure limit rules, and independent review requirements. Management has consistently maintained its liquidity and contingency threshold of five percent of on-balance sheet assets. Management has appropriate policies and procedures for forecasting short- and long-term liquidity needs. Risk limits are in place to ensure sufficient liquidity levels, and management evaluates limits and pertinent metrics on a daily, weekly, and monthly basis. The Market Risk Oversight (MRO) group monitors exposures relative to risk limits on a regular basis; however, MRO lacks the ability to independently validate the reported metrics or establish policy/risk limits.

SENSITIVITY TO MARKET RISK

Interest rate risk management is satisfactory. Sensitivity to market risk reflects the degree to which changes in interest rates can adversely affect the Enterprise's earnings and capital. During 2005, Enterprise management demonstrated an appropriate ability to identify, measure, monitor, and control market risk in a manner commensurate with the nature and complexity of the Enterprise's activities. Quantitative measures of the Enterprise's sensitivity to market risk exposures—such as, Portfolio Market Value Sensitivity (PMVS) and duration gap—reflect that earnings and capital are appropriately protected against significant movements in market rates.

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As of December 31, 2005, PMVS, duration gap, and convexity were within the Board's approved measures of interest rate risk. PMVS measures the estimated loss in pre-tax portfolio market value as a result of instantaneous rate and yield curve shocks. PMVS is measured in two ways: PMVS-L estimates the loss in pre-tax portfolio market value from an immediate adverse 50 basis-point parallel shift in the level of LIBOR rates. PMVS-YC estimates the loss in pre-tax portfolio market value from an immediate adverse 25 basis point change in the slope of the LIBOR yield curve. PMVS is a measure that encompasses both the duration and convexity components of interest rate risk; however, in December 2005, the Board amended its Asset Liability Management policy and adopted separate limits for duration gap and convexity. In addition, the Board lowered the limits set for duration gap and PMVS from ≤ 6 months and 15 percent, respectively, to ≤ 3 months and 7.5 percent, respectively. The Board introduced a new convexity limit of ≤ 6 months. In 2005, management maintained PMVS and duration gap at monthly averages of 1 percent and 0 months, respectively. Management has adopted a variety of additional risk metrics and attendant limits and maintained exposures within those limits throughout the year. The PMVS levels and other metrics observed in 2005 indicate that market risk sensitivity is well-controlled. There is limited potential that the Enterprise's earnings performance or capital position will be adversely affected.

Notwithstanding the favorable risk measures described above, the overall interest rate risk governance framework lacks the formality (in terms of documented strategies, policies, and procedures) appropriate for a large, regulated financial institution. For example, we found that management had rapidly expanded both the non-agency asset-backed security (ABS) portfolio and the CMBS portfolio in the absence of specific, written investment strategies, policies, and portfolio limits. In each case, management experienced unforeseen financial and operational problems related to these portfolios that required a revision of reported earnings (in the case of the non-agency ABS portfolio) and significant errors in internal risk measures (in the case of the CMBS portfolio).

The Board and management are addressing the shortcomings we have identified in the framework during the normal course of business. Given the Enterprise's limited exposures to interest rate risk and substantial capital position, the shortcomings in the governance framework do not give rise to immediate safety and soundness concerns.

EARNINGS

Earnings are satisfactory. Reported income may change as the Enterprise continues to address accounting and control related issues. Preliminary GAAP reported earnings declined 14 percent to \$2.5 billion, from \$2.9 billion in 2004. The decline was primarily due to lower net interest income, higher credit-related expenses, and unexpected accounting adjustments.

The net interest income was down sharply due to lower spreads on new business and the impact of rate increases on funding sources and accounting classification changes on income from derivatives. Credit-related expenses (loan loss provision plus real estate

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owned operations expense) rose as the Enterprise increased its loan loss provision due to expected losses associated with the Gulf Coast Hurricanes. Real estate owned operations expenses rose due partly to longer holding periods as the housing market slowed during the latter half of 2005.

For 2006, the Enterprise anticipates net income to reach \$3.2 billion. The Enterprise is basing its net income forecast on the following assumptions:

- Retained portfolio growth of 8%
- Guarantee portfolio growth of 11%
- Continued lower margins on new purchase activity (e.g. mortgage-related ABS sector)
- Further compression in the guarantee fee rate due to competition
- Reduced derivative losses
- Increased realized credit losses due to Gulf Coast Hurricanes
- Marginal increase in administrative expenses due to increased staffing

CAPITAL

Regulatory capital is adequate which is the highest rating assigned by OFHEO. OFHEO's Office of Capital Supervision formally classifies capital adequacy on a quarterly basis 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. OFHEO imposed a capital surcharge of 30 percent of the minimum capital surplus for Freddie Mac in January 2004 due to increased operational risk.

On March 31, 2006, OFHEO announced that it had classified Freddie Mac as adequately capitalized as of December 31, 2005. As of that date, the core capital of the Enterprise exceeded its minimum capital requirement by approximately 45 percent. OFHEO classified Freddie Mac as adequately capitalized for the three preceding quarters of 2005. During those periods, Freddie Mac maintained a minimum capital surplus in excess of the capital surcharge. OFHEO supports its capital classifications through a combination of compulsory capital reporting, weekly monitoring, analysis of changes in the Enterprises capital requirements and analysis of trends in risk factors that could impact the adequacy of capital.

OFHEO's capital classification of Freddie Mac 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 classification is subject to revision based on results from Freddie Mac's ongoing audit, management reviews, and control assessments.

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CONSENT ORDER

Freddie Mac has achieved technical compliance with the Consent Order. Management is committed to addressing all issues related to this Order as evidenced by the implementation of multi-year project plans. OFHEO will continue to monitor management's progress with these plans. The internal control framework - particularly in the areas of financial management and reporting, internal audit and accounting, and cultural change requires ongoing work by the Enterprise.