United States General Accounting Office

GAO

Report to the Congress

September 1989

FINANCIAL AUDIT

Federal Home Loan Mortgage Corporation's 1988 Financial Statements

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-179312

September 22, 1989

To the President of the Senate and the
Speaker of the House of Representatives

This report presents the results of our review of the independent certified public accountants' audit of the Federal Home Loan Mortgage Corporation's consolidated financial statements for the year ended December 31, 1988. In the auditors' opinion, the Federal Home Loan Mortgage Corporation's statements are fairly presented, in all material respects, in accordance with generally accepted accounting principles. The independent auditors' reports on the Corporation's internal control structure and on its compliance with laws and regulations are also provided.

The Federal Home Loan Mortgage Corporation is a stockholder-owned corporation chartered by the Congress in 1970 to create a continuous flow of funds to mortgage lenders in support of home ownership and rental housing. It was created pursuant to the Federal Home Loan Mortgage Corporation Act, Title III of the Emergency Home Finance Act of 1970, as amended (12 U.S.C. 1451-1459). The principal activity of the Corporation currently consists of purchasing first lien, conventional residential mortgages, including participation interests in such mortgages. The Corporation then resells them in the form of single-class guaranteed mortgage securities, primarily various types of Mortgage Participation Certificates. The Corporation guarantees to certificate holders timely payment of interest and the ultimate collection of principal.

Until August 9, 1989, when the Financial Institutions Reform, Recovery and Enforcement Act of 1989 was signed by the President, the three members of the Federal Home Loan Bank Board served as the Corporation's Board of Directors. The act changes the composition of the Corporation's Board of Directors and provides the Secretary of the Department of Housing and Urban Development with general regulatory power over the Corporation.

Over the past 5 years, the Corporation has experienced uninterrupted growth in earnings, assets, and portfolio size. However, given the fundamental changes occurring in the mortgage industry today, such as increased competition and fewer mortgage originations, the Corporation believes it will be difficult to duplicate this growth over the next few years. Additional information on the Corporation and its activities is provided in the notes to consolidated financial statements, which are included in this report.

The Corporation contracted with an independent certified public accounting firm, Arthur Andersen & Co., to perform a financial and compliance audit of its 1988 consolidated financial statements. Our review was conducted pursuant to 12 U.S.C. 1456(b), which authorizes the Comptroller General to audit the Corporation's financial transactions in accordance with the principles and procedures applicable to commercial corporate transactions. To fulfill our audit responsibilities, avoid duplication and unnecessary expense, and make the most efficient use of our available resources, we reviewed the independent auditors' work and reports.

We conducted our review of the auditors' work in accordance with generally accepted government auditing standards. To determine the reasonableness of the auditors' work and the extent to which we could rely on it, we

- reviewed the auditors' approach and planning of the audit,
- evaluated the qualifications and independence of the audit staff,
- reviewed the financial statements and auditors' reports to evaluate compliance with generally accepted accounting principles and generally accepted government auditing standards, and
- reviewed the auditors' working papers to determine (1) the nature, timing, and extent of audit work performed, (2) the extent of the audit quality control methods the auditors used, (3) whether an understanding was obtained of the entity's internal control structure, (4) whether the auditors tested transactions for compliance with applicable laws and regulations, and (5) whether the evidence in the working papers supported the auditors' opinion on the financial statements and the internal control structure and compliance reports.

In the opinion of Arthur Andersen & Co., the Federal Home Loan Mortgage Corporation's consolidated financial statements present fairly, in all material respects, its financial position as of December 31, 1988, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles. Also, Arthur Andersen & Co.'s reports to the Corporation on its internal control structure and on its compliance with laws and regulations did not disclose any material internal accounting control weaknesses or noncompliance with laws and regulations.

During our review, we found nothing to indicate that Arthur Andersen & Co.'s opinion on the Corporation's 1988 consolidated financial statements is inappropriate or cannot be relied on. Nor did we find anything to indicate that the auditors' reports on the Corporation's internal control structure and on its compliance with laws and regulations are inappropriate or cannot be relied on.

During the course of its audit, Arthur Andersen & Co. identified several matters which, although not material to the financial statements, were communicated for the Federal Home Loan Mortgage Corporation's consideration in a separate management letter.

We believe that the consolidated financial statements, together with Arthur Andersen & Co.'s opinion and our review of that work, provide the Congress with a dependable basis for evaluating the Corporation's financial position. This report presents the Corporation's financial statements and the auditors' opinion thereon. We did not review the auditors' work supporting its opinion on the 1987 and 1986 financial statements.

We are sending copies of this report to the Director of the Office of Management and Budget; the Secretaries of the Treasury and of Housing and Urban Development; the Chairman of the Senate Committee on Banking, Housing and Urban Affairs; the Chairman of the House Committee on Banking, Finance and Urban Affairs; and the Board of Directors of the Federal Home Loan Mortgage Corporation.

Brian P. Crowley for

Charles A. Bowsher
Comptroller General
of the United States

Contents

Auditors' Opinion

To the Board of Directors of the
Federal Home Loan Mortgage Corporation:

We have audited the accompanying Consolidated Balance Sheets of the Federal Home Loan Mortgage Corporation (a federally chartered corporation) as of December 31, 1988 and 1987, and the related Consolidated Statements of Income, Stockholders' Equity and Cash Flows for each of the three years in the period ended December 31, 1988. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Federal Home Loan Mortgage Corporation as of December 31, 1988 and 1987, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1988, in conformity with generally accepted accounting principles.

ARTHUR ANDERSEN & CO.

Washington, D.C.,

February 10, 1989.

Auditors' Report on Internal Control Structure

ARTHUR ANDERSEN & CO.
WASHINGTON, D. C.

Report of Independent Public Accountants
on Internal Control Structure

To the Board of Directors of the
Federal Home Loan Mortgage Corporation:

We have audited the consolidated financial statements of Federal Home Loan Mortgage Corporation ("FHLMC") for the year ended December 31, 1988, and have issued our report thereon dated February 10, 1989. We conducted our audit in accordance with generally accepted auditing standards and the standards for financial audits contained in the U.S. General Accounting Office Government Auditing Standards (1988 Revision).

In planning and performing our audit of the financial statements of FHLMC for the year ended December 31, 1988, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of FHLMC is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. Among the objectives of the internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the internal control structure to future periods is subject to the risk it may become inadequate because of changes in conditions or deterioration in its operating effectiveness.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following cycles:

Treasury
Mortgage Loan and Investor
Expenditure
Financial Reporting

For all of the internal control structure cycles listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

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Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the use of management, the Board of Directors and the U.S. General Accounting Office. This restriction is not intended to limit the distribution of this report which, upon acceptance by the U.S. General Accounting Office, is a matter of public record.

Arthur Andersen & Co.

February 10, 1989.

Auditors' Report on Compliance With Laws and Regulations

ARTHUR ANDERSEN & CO.

WASHINGTON, D. C.

Report of Independent Public Accountants
on Compliance with Laws and Regulations

To the Board of Directors of the
Federal Home Loan Mortgage Corporation:

We have audited, in accordance with generally accepted auditing standards and the standards for financial audits contained in the U.S. General Accounting Office Government Auditing Standards (1988 Revision), the consolidated balance sheet of Federal Home Loan Mortgage Corporation ("FHLMC") as of December 31, 1988, and the related consolidated statements of income, stockholders' equity and cash flows for the year then ended, and have issued our report thereon dated February 10, 1989.

The management of FHLMC is responsible for FHLMC's compliance with laws and regulations. In connection with our audit referred to above, we selected and tested transactions and records to determine FHLMC's compliance with laws and regulations, noncompliance with which could have a material effect on the consolidated financial statements of FHLMC.

The results of our tests indicate that, for the items tested, FHLMC complied with those provisions of laws and regulations, noncompliance with which could have a material effect on the consolidated financial statements. Nothing came to our attention that caused us to believe that, for the items not tested, FHLMC was not in compliance with laws or regulations, noncompliance with which could have a material effect on FHLMC's consolidated financial statements.

This report is intended solely for the use of management, the Board of Directors and the U.S. General Accounting Office. This restriction is not intended to limit the distribution of this report, which, upon acceptance by the U.S. General Accounting Office, is a matter of public record.

Arthur Andersen & Co.

February 10, 1989.

Financial Statements

Consolidated Balance Sheets

(dollars in millions)

December 31,	1988	1987
Assets		
Mortgages, at unpaid principal balances (including approximately $636 million and $748 million held for sale in 1988 and 1987, respectively):		
Single-family fixed-rate	$ 9,218	$ 6,481
Single-family adjustable rate	1,033	1,211
Multifamily	1,878	997
Mortgages financed by multiclass debt securities	5,296	4,183
	17,425	12,872
Less—Unamortized mortgage purchase discount	(507)	(518)
—Reserve for loan losses	(103)	(96)
Total mortgages, net	16,815	12,258
Cash and investments	5,525	4,670
Mortgage securities purchased under agreements to resell (market value of $9.3 billion in 1988 and $6.2 billion in 1987)	9,107	5,859
Unamortized mortgage sales discount	1,172	1,387
Accounts receivable and other assets	1,321	1,160
Real estate owned, net	224	175
Accrued interest receivable	188	165
	$ 34,352	$ 25,674
Liabilities and Stockholders' Equity		
Debt securities, net:		
Notes and bonds payable:		
Due within one year	$ 18,482	$ 12,300
Due after one year	1,620	1,509
Total notes and bonds payable	20,102	13,809
Multiclass debt securities:		
Due within one year	265	351
Due after one year	4,479	3,301
Total multiclass debt securities	4,744	3,652
Total debt securities, net	24,846	17,461
Income taxes currently payable	216	256
Accrued interest and other accrued expenses	370	259
Principal and interest due to Mortgage Participation Certificate investors	5,011	4,192
	30,443	22,168
Reserve for uninsured principal losses on sold mortgages	289	238
Contingencies		
Guarantees:		
Mortgage Participation Certificates and Guaranteed Mortgage Certificates	226,406	212,635
Less—Underlying mortgages sold	(226,406)	(212,635)
	—	—
Subordinated borrowings	2,036	2,086
Stockholders' equity:		
Capital stock:		
Senior participating preferred stock, $2.50 par value, up to 60,000,000 shares authorized, 59,917,376 shares issued, 59,910,216 shares outstanding at December 31, 1988	150	—
Preferred stock, $10 par value, 20,656 shares authorized, issued and outstanding at December 31, 1988	—	—
Participating preferred stock, $10 par value, 15,000,000 shares authorized and issued, 14,998,210 outstanding at December 31, 1987	—	150
Common stock, $1,000 par value, 100,000 shares issued and outstanding at December 31, 1988 and 1987	100	100
Additional paid-in capital	104	—
Retained earnings	1,230	932
Total stockholders' equity	1,584	1,182
	$ 34,352	$ 25,674

See accompanying notes to consolidated financial statements.

Consolidated Statements of Income

(dollars in millions, except per share amounts)

Year Ended December 31,	1988	1987	1986
Income from total portfolio:			
Interest and discount on mortgages:			
Retained mortgage portfolio	$ 1,090	$ 777	$ 885
Mortgages financed by multiclass debt securities	479	499	626
	1,569	1,276	1,511
Interest on investments and mortgage securities purchased under agreements to resell	833	627	357
Management and guarantee income	465	472	301
	2,867	2,375	2,169
Interest and related expenses:			
Interest on debt securities:			
Short-term notes and bonds	(995)	(482)	(288)
Long-term notes and bonds	(384)	(420)	(428)
Multiclass debt securities	(404)	(520)	(678)
	(1,783)	(1,422)	(1,394)
Interest expense on principal held for Mortgage Participation Certificate investors	(127)	(162)	(175)
	(1,910)	(1,584)	(1,569)
Net interest margin on portfolio	957	791	600
Provision for loan losses	(204)	(175)	(120)
Net interest margin after provision for loan losses	753	616	480
Administrative expenses	(194)	(150)	(110)
Gain (loss) on sale of mortgages, net	(2)	13	31
Other income (expense), net	(3)	1	41
Income before income taxes	554	480	442
Provision for income taxes	(173)	(179)	(195)
Net income	$ 381	$ 301	$ 247
Earnings per share:			
Earnings per preferred share	$ 5.73	$ 4.53	$ 3.72
Earnings per common share	$370.99	$290.92	$236.77

See accompanying notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

(dollars in millions)

	Number of Shares Outstanding				Par Value						
	Participating Preferred Stock	Senior Participating Preferred Stock	Preferred Stock	Common Stock	Participating Preferred Stock	Senior Participating Preferred Stock	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Total Stockholders' Equity
Balance, January 1, 1986	14,998,379	—	—	100,000	$ 150	$—	$—	$100	$—	$ 529	$ 779
Net income										247	247
Dividends:											
Common stock										(5)	(5)
Participating preferred stock										(68)	(68)
Less-Treasury stock	(169)										—
Balance, December 31, 1986	14,998,210	—	—	100,000	150	—	—	100	—	703	953
Net income										301	301
Dividends:											
Common stock										(6)	(6)
Participating preferred stock										(66)	(66)
Balance, December 31, 1987	14,998,210	—	—	100,000	150	—	—	100	—	932	1,182
Net income										381	381
Dividends:											
Common stock										(8)	(8)
Participating preferred stock										(75)	(75)
Preferred stock exchange	(14,998,210)	59,910,216	20,656		(150)	150			104		104
Balance, December 31, 1988	—	59,910,216	20,656	100,000	$ —	$150	$—	$100	$104	$1,230	$1,584

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(dollars in millions)

Year Ended December 31,	1988	1987	1986
Cash Flows From Operating Activities:			
Net income	$ 381	$ 301	$ 247
Adjustments to reconcile net income to net cash provided by (used for) operating activities:			
Amortization of mortgage purchase discount	(101)	(50)	(49)
Amortization of mortgage sales discount	194	138	83
Amortization of deferred debt expense	126	132	114
Provision for loan losses	204	175	120
Net increase (decrease) in payables and receivables	804	(2,629)	3,953
	1,227	(2,234)	4,221
Mortgages purchased for resale	(10,812)	(16,153)	(43,439)
Mortgages sold	10,842	17,716	41,121
	30	1,563	(2,318)
Net Cash Provided by (Used for) Operating Activities	1,638	(370)	2,150
Cash Flows From Investing Activities:			
Mortgages purchased for multiclass debt securities	—	—	(1,295)
Mortgages purchased and held as investments	(4,463)	(3,498)	(228)
Mortgage principal repayments	1,452	2,317	3,828
Net (increase) decrease in mortgage securities purchased under agreements to resell	(3,248)	(1,364)	(3,986)
Net Cash Used in Investing Activities	(6,259)	(2,545)	(1,681)
Cash Flows From Financing Activities:			
Multiclass debt securities issued	—	—	2,183
Multiclass debt securities retired	(683)	(1,722)	(2,036)
	(683)	(1,722)	147
Notes and bonds issued	122	—	986
Notes and bonds retired	(161)	(1,083)	(381)
	(39)	(1,083)	605
Proceeds from preferred stock exchange	104	—	—
Dividends paid	(89)	(66)	(58)
Net increase in short-term borrowings	6,183	6,844	1,762
Net Cash Provided by Financing Activities	5,476	3,973	2,456
Net increase in cash and investments	855	1,058	2,925
Cash and investments at January 1,	4,670	3,612	687
Cash and investments at December 31,	$ 5,525	$ 4,670	$ 3,612

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

for the years ended December 31, 1988, 1987 and 1986

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial reporting and accounting policies of the Federal Home Loan Mortgage Corporation ("Freddie Mac") conform to generally accepted accounting principles. Certain prior year amounts have been reclassified to conform with current financial statement presentation. The following is a summary of the significant accounting policies:

Accounting for Mortgage Sales

Freddie Mac sells single-class Mortgage Participation Certificates (PCs) and has sold Guaranteed Mortgage Certificates (GMCs), representing undivided interests in primarily conventional mortgages. Freddie Mac also sells Multiclass PCs, each series representing beneficial ownership interests in specific pools of single-class PCs. The sold certificates are accounted for as a sale of assets and, accordingly, the mortgages sold are excluded from Freddie Mac's retained mortgage portfolio. Because Freddie Mac guarantees PC holders (1) the timely payment of interest at the PC and GMC certificate rate, (2) the timely payment of principal on mortgages underlying certain PCs, (3) the ultimate payment of principal on mortgages underlying all PCs, and (4) the scheduled payment of principal on GMCs, they are reflected on the accompanying Consolidated Balance Sheets as contingent liabilities.

A separate trust has been established for each GMC issue. Freddie Mac serves as Trustee and is primarily responsible for forwarding principal collections and interest to GMC investors and for conducting the investment transactions prescribed in accordance with the terms of each Indenture of Trust.

Several classes of certain series of Multiclass PCs have been issued with a mandatory purchase obligation (MPO) that entitles the holder to a one time option to exercise a put on the securities to Freddie Mac, at par, on a specific date. The existence of the MPO precludes accounting for these classes as a sale of assets, therefore, the series of Multiclass PCs and the related mortgages are treated as debt financings and retained mortgages, respectively, in the accompanying financial statements.

Recognition of Gains and Losses on Mortgages Sold

Effective financing spread, representing the excess of effective interest income to Freddie Mac on mortgages sold under the PC and GMC programs over that payable to the PC and GMC investors, is recognized as income over the life of the related sold mortgages and is reported as "Management and guarantee income" in the accompanying Consolidated Statements of Income.

Freddie Mac recognizes losses currently on sales of mortgages and on outstanding commitments that do not result in sufficient interest margin to cover the anticipated expenses and potential losses to be incurred by Freddie Mac over the life of the securities and to make a contribution to earnings.

Freddie Mac provides currently for possible losses on mortgages, either retained in portfolio or sold under the PC and GMC programs, by establishing reserves that represent management's estimate of possible foreclosure losses. Actual foreclosure losses representing the difference between the carrying value of the mortgage and the net realizable value of the real estate acquired in settlement of the foreclosed mortgage, are charged against the "Reserve for loan losses" or "Reserve for uninsured principal losses on sold mortgages," as appropriate (see Note 4).

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Gains were recorded at the date of the sale for certain transactions which occurred outside of Freddie Mac's regular PC sales programs during 1986 and 1987. These gains represented the net present value of the additional interest income anticipated to be received over the effective financing spread which results from comparable transactions in the regular PC sales programs.

Mortgages Held for Sale

Mortgages held for sale are reported at the lower of cost or market as determined from outstanding commitments from investors or current investor yield requirements. The lower of cost or market is calculated based on the aggregate of all such mortgages for each of the major product categories that are available for sale. Transfer of mortgages to long-term investment is made at the lower of cost or market. In the aggregate, the market value of mortgages held for sale exceeded their cost at December 31, 1987. An unrealized loss of $0.5 million was recorded as an adjustment to "Other income (expense), net" at December 31, 1988 to adjust the $636 million carrying value of mortgages currently held for sale, including $38 million not matched with sale commitments, to the lower of cost or market.

Mortgage Sales and Purchase Discount

Discount on the sale of PCs and GMCs is amortized over the estimated weighted average life of the underlying mortgages using the effective interest method. Amortization of sales discount is recorded as a reduction of "Management and guarantee income" in the accompanying Consolidated Statements of Income. "Unamortized mortgage sales discount" is shown net of the unamortized mortgage purchase discount for mortgages underlying the PCs and GMCs.

Fees received in connection with the resecuritization of existing PCs are deferred and amortized over the estimated weighted average life of the underlying mortgages using the effective interest method. The amortization is recorded as additional "Management and guarantee income" in the accompanying Consolidated Statements of Income.

Discount on mortgages purchased is recorded as income over the weighted average life of the related mortgages using the effective interest method. Amortization of purchase discount is recorded as an increase in "Interest and discount on mortgages:" in the retained portfolio and as an increase in "Management and guarantee income" for mortgages sold via the PCs and GMCs in the accompanying Consolidated Statements of Income.

During the third quarter of 1988, Freddie Mac completed a study of the weighted average life estimates of its mortgage portfolio. Historically, Freddie Mac has periodically reviewed the weighted average lives of its mortgage portfolio. The results of the study indicate that, to better reflect actual prepayment experience of its mortgage portfolio, the weighted average life estimates for mortgages with scheduled maturities of 25 to 30 years should be changed from approximately 10 years to approximately 8.5 years and for mortgages with scheduled maturities of 15 years, the life should be changed from approximately 7 years to approximately 6 years. The new weighted average life estimates are used to amortize discount beginning in September 1988. Additionally, cumulative adjustments were recorded to reflect the revised estimates, resulting in increased income of $51 million from accelerated amortization of purchase discount and increased expense of $54 million from accelerated amortization of sales discount. These adjustments are reflected in the accompanying Consolidated Statements of Income in "Interest and discount on mortgages" and "Management and guarantee income," respectively. The net effect of the adjustments was to reduce "Income before income

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

taxes" and "Net income" by approximately $3 million and $2 million, respectively. The portion of the cumulative adjustment attributable to years prior to 1988 increased reported net income by $.4 million.

Amortization of Deferred Debt Expense

Deferred debt issuance costs are amortized over the period during which the related indebtedness is outstanding. Deferred debt issuance costs relating to the zero coupon capital debentures (see Note 10) and the multiclass debt securities (see Note 9) are amortized using the effective interest method. All other debt expense is amortized on a straight-line basis which produces results that are not materially different from the results of the effective interest method.

Hedging Transactions

Freddie Mac has utilized a strategy of managing its interest rate risk on anticipated debt issuances, option contract settlements, PC pricing, inventory maintenance and retail sales activities by taking positions in cash market trades, futures contracts, futures options and over-the-counter options. Gains and losses resulting from these hedging transactions were deferred to the extent that the hedging transactions were effective in reducing interest rate risk and are being recognized over the lives of the related hedged items. Management decided to discontinue hedging transactions and to increase total mortgage inventory holdings to assist in managing overall interest rate risk during the fourth quarter of 1987. The last hedged position was closed during February 1988.

Accounting for PC Program Variances

At the end of each monthly mortgage remittance processing cycle, a difference between the PC program security and related mortgage balances (the "Variance") exists because there are timing differences inherent in the design of the PC program resulting from a delay between collections and disbursements of mortgage collections by Freddie Mac.

"Interest expense on principal held for Mortgage Participation Certificate investors" separately discloses the impact of the timing differences in the accompanying Consolidated Statements of Income, as interest continues to be paid on the higher PC balances after Freddie Mac has collected the principal on the mortgages. The effect of the timing differences was previously included in "Management and guarantee income." The reported amounts for 1987 and 1986 have been reclassified in the accompanying Consolidated Statements of Income to be consistent with this method of presentation. The temporary investment of the mortgage collections serves to generate float income to Freddie Mac which is reflected in "Interest on investments and mortgage securities purchased under agreement to resell." The collected principal may also be used for financing, thereby temporarily reducing short-term debt. As principal repayment activity increases, the difference between mortgage and security balances will widen. Freddie Mac will record increased expense on a higher security balance as well as obtain an increase in the available funds which the corporation is entitled to temporarily invest, at its own risk and for its own benefit, until disbursement to PC holders.

Commitment Fees

In 1986, "Other income (expense), net" includes commitment fee income net of commitment fee expense as well as other types of fee income associated with acquiring mortgages. Non-refundable commitment fees were recognized as income or expense when the commitments were made. Refundable commitment fees were, and continue to be, returned upon mortgage purchase or recognized at the end of the commitment period if

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

delivery was not made. Beginning in 1987, Freddie Mac defers and amortizes all nonrefundable commitment fees, as required by SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases." This change in accounting does not materially affect reported net income.

Consolidated Statements of Cash Flows

As required by SFAS No. 95, "Statement of Cash Flows," Freddie Mac has included a Consolidated Statement of Cash Flows in its 1988 financial statements, and has included comparative statements for the years ended December 31, 1987 and 1986. For purposes of reporting cash flows, Freddie Mac considers "Cash and investments" to be cash and cash equivalents. Freddie Mac has used the indirect method of presentation. During 1988, 1987 and 1986 the corporation made interest payments totalling $1.7 billion, $1.3 billion and $1.5 billion, respectively. The corporation paid $213 million, $250 million and $10 million in income tax payments during 1988, 1987 and 1986.

Freddie Mac enters into noncash transactions involving the securitization of mortgages or resecuritization of existing PCs. These noncash transactions include (1) the exchange of mortgages with a seller for a like amount of PCs, backed by the identical mortgages (Guarantor program), (2) the exchange of existing Freddie Mac PCs with a seller for an interest in a Freddie Mac PC, backed by a group of PCs exchanged under the program (Giant PC program), and (3) the exchange of existing single-class PCs with a seller for a like amount of a multiclass PC, backed by the identical single-class PCs. The following table summarizes activity for these noncash transactions.

	Year ended December 31,		
	1988	1987	1986
	(dollars in millions)		
PCs issued under Guarantor program	$28,728	$57,083	$58,399
Giant PCs	6,501	—	—
Multiclass PCs	11,235	—	—
Multiclass PCs with MPOs	1,750	—	—

Accounting for Income Taxes

In December 1987, the FASB issued SFAS No. 96, "Accounting for Income Taxes." This SFAS supersedes APB Opinion No. 11, "Accounting for Income Taxes," primarily by requiring an asset and liability approach for financial accounting and reporting for income taxes. SFAS No. 96, as amended, need not be applied until Freddie Mac's fiscal year ending December 31, 1990, although earlier application is permissible.

SFAS No. 96 may be adopted by reporting a cumulative catch-up adjustment in the year of adoption. Alternatively, adoption may be achieved by restatement of prior year statements via either reporting a cumulative catch-up adjustment in the earliest year of restatement, or reporting an adjusted beginning retained earnings balance if the first year of restatement precedes the earliest year reported. As of December 31, 1988, management was in the process of assessing the impact of SFAS No. 96 on Freddie Mac's financial statements and establishing the timing and method of implementation.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Earnings per Share

Earnings per share are based on weighted average number of shares of preferred stock outstanding during the year and are calculated in accordance with the preference in dividend distribution described in Note 11. In calculating the earnings per share, the actual weighted average number of participating preferred shares outstanding of 14,998,210 in 1988 and 1987 and 14,998,287 in 1986 have been restated for comparative purposes as if the exchange for senior participating preferred stock had occurred on January 1, 1986.

Consolidated Financial Statements

In December 1986, Freddie Mac purchased a 75 percent interest in the West*Mac Associates Limited Partnership (West*Mac) which is the owner and developer of Freddie Mac's future corporate headquarters. Accordingly, the consolidated financial statements include the accounts of Freddie Mac and this majority-owned joint venture subsidiary. At December 31, 1988 and 1987, West*Mac had net worth of $38 million and assets totalling $71 million and $59 million, respectively. The minority partners' interests are immaterial in relation to Freddie Mac's financial statements, and are included in "Accrued interest and other accrued expenses" in the accompanying 1988 and 1987 Consolidated Balance Sheets.

2. MORTGAGE SALES AND RELATED MATTERS

PCs and GMCs

Holders of PCs receive interest monthly at the coupon rate together with their pro rata share of principal payments received by Freddie Mac on the mortgages backing the PCs. Unpaid principal balances of the outstanding single-class PCs were approximately $214.7 billion and $211.7 billion at December 31, 1988 and 1987, respectively.

Freddie Mac has not issued GMCs since December 1979. Unpaid balances of the outstanding GMCs at December 31, 1988 and 1987 totalled less than one billion dollars for each year.

Guarantees

The maximum contingent liability of $226.4 billion and $212.6 billion at December 31, 1988 and 1987, respectively, is offset by the same amount of interest-bearing mortgages underlying the PCs and GMCs, including principal collections held in the GMC Trusts of $98 million at December 31, 1988 and $135 million at December 31, 1987.

Effective Financing Spread

At December 31, 1988 and 1987, the effective interest income rate to Freddie Mac over that payable to the PC and GMC holders was 23.1 basis points and 24.9 basis points, respectively. When appropriate, the effective interest income rate to Freddie Mac and the effective rate payable have been adjusted to semiannual yield equivalents, and are adjusted for the effect of amortization of deferred charges. The 1987 yield has been revised to eliminate the adjustment for the expected value of reinvestment of collections pending disbursement to PC and GMC holders that had been included in prior years.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

3. MORTGAGES

As of December 31, 1988 and 1987, the effective net yields on the net mortgages adjusted for the effect of purchase discount amortization, were as follows:

	December 31,			
	1988		1987	
	Balance	Yield	Balance	Yield
	(dollars in millions)			
30-year single-family fixed-rate mortgages	$ 7,247	10.37%	$ 4,868	9.83%
15-year single-family fixed-rate mortgages	1,774	10.04	1,442	9.75
Second mortgages	164	10.28	129	10.01
Other single-family fixed-rate mortgages	33	12.91	42	11.18
Single-family adjustable rate mortgages	1,033	9.04	1,211	8.44
Multifamily mortgages	1,878	11.61	997	11.43
Mortgages financed by multiclass debt securities	5,296	10.90	4,183	11.57
	17,425		12,872	
Less-Unamortized mortgage purchase discount	(507)		(518)	
Net mortgages	16,918	10.56%	12,354	10.37%
Less-Reserve for loan losses	(103)		(96)	
Total mortgages, net	$16,815		$12,258	

The effective yields shown above have been determined based on mortgage balances net of unamortized purchase discount. At December 31, 1988 and 1987, the amount reported within the financial statements under "Single-family fixed-rate" mortgages includes outstanding balances of $309 million and $268 million, respectively, of multifamily plan A mortgages. These particular mortgages are pooled with 30-year single-family fixed-rate mortgages and therefore are most properly reflected within this category.

4. LOAN LOSS RESERVES

Freddie Mac maintains reserves to provide for losses on the total mortgage portfolio. The "Reserve for loan losses" in the accompanying Consolidated Balance Sheets is maintained for losses on mortgages retained in portfolio, including those mortgages which are pledged for, or financed by, multiclass debt securities. "Reserve for uninsured principal losses on sold mortgages" in the accompanying Consolidated Balance Sheets provides for losses resulting from borrower default on mortgages underlying PCs and GMCs sold.

Losses include acquisition losses as property is transferred to real estate owned and recorded at the lower of cost or estimated net realizable value (see Note 7). Mortgage insurance proceeds may offset acquisition losses up to the book value of the mortgage in foreclosure.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

An analysis of reserves for the years ended December 31, 1988, 1987 and 1986 follows:

	Year ended December 31, 1988	1987	1986
	(dollars in millions)		
Reserve for loan losses:			
Beginning balance	$ 96	$ 81	$ 61
Provision for loan losses	53	46	32
Acquisition losses	(46)	(31)	(12)
Ending balance	103	96	81
Reserve for uninsured principal losses on sold mortgages:			
Beginning balance	238	197	150
Provision for loan losses	151	129	88
Acquisition losses	(100)	(88)	(41)
Ending balance	289	238	197
Total reserves for losses on mortgages:			
Beginning balance	334	278	211
Provision for loan losses	204	175	120
Acquisition losses	(146)	(119)	(53)
Ending balance	$ 392	$ 334	$278

Depressed economic conditions in certain sections of the United States have led to increased mortgage delinquencies, particularly in those areas dependent on the energy industry, such as the Southwest. The resultant increase in foreclosures in these areas is a primary reason for the significant increase in losses since 1986.

Freddie Mac is subject to risk in connection with insolvencies of seller/servicers, as well as risk resulting from financial instability of certain sectors of the mortgage insurance industry. In particular, claims against TMIC Insurance Company Inc. ("TMIC"), which are currently pending resolution, and mortgages formerly insured by TMIC may not be fully recoverable. However, Freddie Mac believes that all losses which will result from claims against TMIC and mortgages formerly insured by TMIC have been adequately provided for in the appropriate loan loss reserves.

5. CASH AND INVESTMENTS

Investments

Investments are reflected in the financial statements at cost, and it is management's intention to hold these securities to maturity. At December 31, 1988 and 1987, the carrying value of investments approximates market value. Approximately 95 percent of the corporation's investments held as of December 31, 1988 mature within one year. Investments outstanding and cash balances as of December 31, 1988 and 1987 are summarized below.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	December 31, 1988	December 31, 1987
	(dollars in millions)	
Eurodollar time deposits	$ 160	$ 340
Equity securities	721	686
Federal funds	4,309	3,177
Obligations of states and political subdivisions	265	340
U.S. Treasury and agency securities	—	25
Other securities	45	40
Total investments	5,500	4,608
Cash	25	62
Total cash and investments	$5,525	$4,670

Restricted Amounts

As of December 31, 1988 and 1987, "Cash and investments" on the accompanying Consolidated Balance Sheets includes $168 million and $188 million, respectively, of cash items restricted for the payment of Collateralized Mortgage Obligation ("CMO") principal and interest. "Multiclass debt securities: Due within one year" includes $112 million and $127 million, respectively, representing principal collected and currently payable to CMO holders. "Accrued interest and other accrued expenses" includes $56 million and $61 million, respectively, representing interest collected and reinvestment income earned which are currently payable to CMO holders.

6. MORTGAGE SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL

In 1986, Freddie Mac began executing mortgage security purchases under agreements to resell with various parties through its Security Sales and Trading Group. The maximum amount, under restrictions provided by the Board of Directors, that Freddie Mac may have outstanding under reverse repurchase agreements with borrowers as of December 31, 1988 was $7.5 billion. The Board authorized temporary additional lending authority in conjuction with the January 1989 issuance of Freddie Mac's first series of funding note pass-through certificates involving Gibraltar Savings. The master agreements governing these transactions provide for delivery of securities collateralizing the agreements to Freddie Mac when the agreements are transacted. While Freddie Mac, in the event of default, has the right to sell the collateral which is subject to the reverse repurchase agreements, the corporation has never experienced a default or other circumstance requiring the exercise of this right. Freddie Mac's right to sell the collateral would not be impaired in the event of receivership proceedings involving the Federal Savings and Loan Insurance Corporation pursuant to a resolution adopted by the Federal Home Loan Bank (FHLB) Board.

These reverse repurchase agreements have maturities of not more than 183 days and may be renegotiated between Freddie Mac and the borrower at maturity. Each time an agreement is renewed, it is repriced in accordance with current market conditions. The reverse repurchase agreements also permit Freddie Mac to obtain collateral in the form of additional securities or cash as margin if the market value of the securities subject to a reverse repurchase agreement falls below a specified level.

Freddie Mac also has a contract to purchase mortgage securities under agreements to resell with New West Federal Savings & Loan (a successor to American Savings and Loan Association of California, effective December 28, 1988). Significant provisions of the contract as of December 31, 1988 include: (1) New West

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

may sell mortgages to Freddie Mac and agree to repurchase the mortgages on a specified later date, (2) New West must exchange the mortgages for Freddie Mac's PCs, and (3) New West may sell PCs to Freddie Mac and agree to repurchase the PCs on a specified later date. The maximum amount of reverse repurchase agreements involving the mortgages and PCs may not, in total, exceed $6 billion.

Freddie Mac's reverse repurchase agreement authorization could result in risks associated with an inability of the market to absorb collateral in the event Freddie Mac were required to liquidate collateral by reason of a borrower's default. The risk is greater where collateral is concentrated in one institution.

Mortgage securities purchased under agreements to resell as of December 31, 1988 and 1987, including the five largest customers, are summarized below.

	December 31, 1988	December 31, 1987
	(dollars in millions)	
New West Federal Savings & Loan	$1,775	$3,368
Gibraltar Savings of Washington, F.A.	812	396
First Federal of Michigan	442	—
TCF Banking and Savings, F.A.	401	—
Great Western Federal Savings Bank	386	292
Other	5,291	1,803
Total mortgage securities purchased under agreements to resell	$9,107	$5,859

7. REAL ESTATE OWNED

In the normal course of business, a portion of the mortgages retained or sold and guaranteed by Freddie Mac will default, be foreclosed upon and result in Freddie Mac's acquisition of the real estate securing the mortgages as real estate owned (REO). The corporation records property transferred in as REO at the lower of cost or estimated net realizable value. At each balance sheet date, Freddie Mac establishes an REO valuation allowance to provide for any decreases in the estimated net realizable value. Upon disposition of the REO, a disposition gain or loss results from deducting the net carrying value of property from sales proceeds. Final disposition gain or loss is recorded against the REO valuation allowance.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

An analysis of Freddie Mac's REO and REO valuation allowance activity in 1988 and 1987 follows:

	Year ended December 31, 1988	1987
	(dollars in millions)	
REO, gross, beginning of year	$ 190	$ 153
Real estate acquired in settlement of mortgages	474	365
Dispositions of REO	(429)	(328)
REO, gross, end of year	235	190
REO valuation allowance, beginning of year	(15)	(23)
Provision for decreases in estimated net realizable value	(15)	(17)
Disposition losses, net	19	25
REO valuation allowance, end of year	(11)	(15)
REO, net, end of year	$ 224	$ 175

8. NOTES AND BONDS PAYABLE

A summary of notes and bonds payable follows:

	Call/ Maturity	December 31, 1988 Balance, Net of Discount	1988 Effective Interest Rate(1)	1987 Balance, Net of Discount	1987 Effective Interest Rate(1)
		(dollars in millions)			
Due within one year:					
Discount notes		$16,226	8.61%	$11,769	7.37%
Mortgage securities sold under agreements to repurchase		—	—	523	7.21
Short-term notes and floating rate debentures		2,248	8.94	—	—
Current portion of long-term debt		8	7.80	8	7.80
Total due within one year		18,482	8.65	12,300	7.36
Due after one year:					
Notes to Federal Home Loan Banks	1983/1993	400	7.38	400	7.38
	1987/1997	300	7.88	300	7.88
		700		700	
Mortgage-backed bonds	1984/1996	49	7.80	60	7.80
	1982/1997	150	7.20	150	7.20
		199		210	
Debentures	1990	122	9.73	—	—
	1990	300	10.94	300	10.94
	1991	299	11.88	299	11.88
		721		599	
Total due after one year		1,620	9.13	1,509	9.08
Total notes and bonds payable		$20,102	8.69%	$13,809	7.55%

(1) The effective interest rates above for notes and bonds payable, excluding "Discount notes" and "Mortgage securities sold under agreements to repurchase," assume interest payments are made on a semiannual basis and are adjusted for the amortization of discounts or premiums, related hedging gains or losses and debt issuance costs, as applicable.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Scheduled principal payments (at par value, based on maturity date) for notes and bonds payable and subordinated borrowings (see Note 10) follow:

(dollars in millions)	
1989	$18,676
1990	416
1991	308
1992	608
1993	407
Thereafter	6,693
Total, at par value	27,108
Unamortized discount	(4,970)
Total, net	$22,138

Discount Notes

The discount notes are unsecured general obligations of Freddie Mac. They are offered on a discounted basis and have maturities of one year or less.

At December 31, 1988 and 1987, discount notes aggregating $9.0 billion and $5.8 billion, net were financing $9.1 billion and $5.9 billion of mortgage securities purchased under agreements to resell (see Note 6).

Mortgage Securities Sold under Agreements to Repurchase

At December 31, 1987, the outstanding agreements, which have maturities up to one year, provide for the sale and repurchase of $515 million of PCs, and $23 million of U.S. Treasury Bills held by the lender as collateral for the $523 million in borrowings, respectively. The agreements are accounted for as financing transactions and, accordingly, the mortgages underlying the PCs used as collateral are included in Freddie Mac's retained mortgage portfolio and the U.S. Treasury Bills are included within temporary investments on the accompanying Consolidated Balance Sheets.

Short-term Notes and Floating Rate Debentures

Short-term notes and floating rate debentures are unsecured general obligations of Freddie Mac with maturities which range up to 361 days. The floating rate debentures are subject to weekly interest rate adjustments tied to the 91-day U.S. Treasury Bill.

Notes to Federal Home Loan Banks

Under section 303(a) of the Federal Home Loan Mortgage Corporation Act (the Act), the corporation is deemed to be a member of each FHLB. As such, Freddie Mac is entitled to borrow from the FHLBs. The notes to the FHLBs represent a pass-through of the FHLBs obligations. The FHLBs are required to maintain certain assets equal to their outstanding consolidated obligations. The corporation is required to maintain certain assets equal to its outstanding consolidated obligation to the FHLBs. In this regard, Freddie Mac may be required to pledge a portion of its mortgages retained in portfolio and/or temporary cash investments to collateralize these obligations for any periods during which the FHLBs do not meet their requirement. In 1981, Freddie Mac discontinued borrowing from the FHLBs and since then has not accessed this source of funds. Currently $700 million of indebtedness to the FHLBs remains outstanding. The notes are currently redeemable at Freddie Mac's option at their face value.

In addition, under section 306(c) of the Act, Freddie Mac's Board of Directors may, at its discretion, cause the FHLBs to guarantee Freddie Mac obligations. The Board of Directors has never employed this guarantee.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Mortgage-backed Bonds

All mortgage-backed bonds are guaranteed as to principal and interest by Government National Mortgage Association (GNMA). Under the provisions of a Trust Indenture with GNMA dated October 26, 1970, and supplements thereto, Freddie Mac conveyed mortgages to the Trust as security for the mortgage-backed bonds. As of December 31, 1988 and 1987, Trust assets of approximately $328 million and $367 million, respectively, constituting primarily the principal balances of such mortgages, are restricted for the payment of principal and interest on the mortgage-backed bonds. These assets are included on the accompanying Consolidated Balance Sheets in the retained mortgage portfolio.

The mortgage-backed bonds are currently redeemable at Freddie Mac's option at their face value. For the 1984/1996 bonds, a sinking fund provides for annual retirements of $7.5 million of the principal amount of bonds. This sinking fund provision commenced in 1977. In addition, Freddie Mac has a non-cumulative option to increase the sinking fund amount each year by an amount which does not exceed the annual retirement amounts. Gains from the repurchase of a portion of the mortgage-backed bonds for the purpose of meeting sinking fund requirements were $0.3 million, $0.2 million and $0.1 million for the years ended December 31, 1988, 1987 and 1986, respectively.

Debentures

The debentures are unsecured general obligations of Freddie Mac. Depending on the issue, they are issued in the minimum principal amount of $10,000 or $5,000 and are not subject to redemption prior to their maturity dates.

9. MULTICLASS DEBT SECURITIES

A summary of mandatory sinking fund payments (or the earliest redemption date) for multiclass debt securities follows:

	December 31,			
	1988		1987	
	Balance, Net of Discount	Effective Interest Rate(1)	Balance, Net of Discount	Effective Interest Rate(1)
	(dollars in millions)			
Due within one year:				
CMOs	$ 237	11.29%	$ 338	11.09%
MCFs	6	7.25	13	7.25
Multiclass PCs	22	8.45	—	—
Total due within one year	265	10.96	351	10.94
Due after one year but within five years:				
CMOs	1,125	10.55	1,290	10.51
MCFs	113	7.68	120	7.06
Multiclass PCs	512	8.64	—	—
Total due after one year but within five years	1,750	9.81	1,410	10.22
Due after five years:				
CMOs	1,357	10.52	1,708	10.40
MCFs	159	8.82	183	8.74
Multiclass PCs	1,213	9.39	—	—
Total due after five years	2,729	9.92	1,891	10.24
Total due after one year	4,479	9.87	3,301	10.23
Total multiclass debt securities	$4,744	9.94%	$3,652	10.30%

(1) The effective interest rates above assume interest payments are made on a semiannual basis and are adjusted for the amortization of discounts or premiums, related hedging gains or losses and debt issuance costs, as applicable.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Multiclass PC balances above have been reduced by $4.2 million for principal collections received by Freddie Mac on the underlying mortgages. These collections are included in "Principal and interest due to Mortgage Participation Certificate investors" in the accompanying Consolidated Balance Sheets.

Multiclass debt securities are collateralized by or finance specific mortgages owned by Freddie Mac and included in the retained portfolio. The number of classes within each series ranges from three to twelve. Certain issues include a class or classes of bonds that have no principal and interest payments (called the accrual class(es)) until all or certain other classes within the issue are paid. On the payment date, additional principal payments will be made to the other classes in an amount equal to the interest accrued on the accrual class(es) of each series of bonds. The unpaid principal balance on the accrual class(es) of each series will be increased by the amount of interest accrued but not paid out. Payments of interest to holders of the accrual class(es) of each series of bonds will commence upon payment in full of all or certain other classes as specified in the offering documents.

Collateralized Mortgage Obligations and Mortgage Cash Flow Obligations

The Collateralized Mortgage Obligations (CMOs) are general obligations of Freddie Mac. Each series of CMOs is secured by a single pool of conventional mortgages. A trust has been established for each CMO issue. Freddie Mac serves as trustee and is responsible for forwarding principal and interest payments to CMO holders and for conducting the investment transactions prescribed in accordance with the terms of the Indenture and Declaration of Trust. Principal collections allocated to the CMO Trusts at December 31, 1988 and December 31, 1987 aggregated $142 million and $167 million, respectively. "Multiclass debt securities: Due within one year" includes $112 million and $127 million, respectively, representing principal collected and currently payable to CMO holders.

The corporation has either repurchased or retained all of the accrual classes of CMO Series E through H and repurchased a portion of one of CMO Series I accrual classes. These bonds are not reflected as outstanding in the accompanying financial statements. The interest accruing to these bonds will be applied as principal payments to the other classes as previously described.

The Mortgage Cash Flow Obligations (MCFs) are unsecured general obligations of Freddie Mac. Freddie Mac is contractually obligated to identify on its books and records a pool of conventional mortgages (the MCF Pool) and may not remove any of the mortgages from the MCF Pool except for substitutions permitted by the MCF agreement. The mortgages included in the MCF Pool are not pledged as collateral for the MCFs. In addition, Freddie Mac must identify the principal and interest payments received on these mortgages as well as invest and remit these receipts and the income from the investment thereof, less a specified deductible amount, to the holders of the MCFs.

Principal and interest on the CMOs and MCFs are payable semiannually at the stated rate for each respective class. Principal payments are allocated to the various classes of each series in the order of the maturities of the classes. Principal payments will be made in an amount at least sufficient to meet the minimum sinking fund schedule or the minimum principal reduction schedule, whichever is applicable. If principal payments are received on the mortgages at a rate in excess of the rate indicated in the schedule, Freddie Mac will be required to remit the excess to the CMO or MCF holders. If the collections on the mortgages are not sufficient to cover the minimum principal reduction payment, Freddie Mac must fund the deficiency.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Multiclass Mortgage Participation Certificates

Several classes of certain series of Multiclass PCs have been issued with a mandatory purchase obligation (MPO) which entitles the holder to a one time option to exercise a put on the securities to Freddie Mac, at par, on a specific date. The existence of the MPO precludes accounting for these classes as a sale of assets, therefore, these series of Multiclass PCs and the related mortgages are treated as debt financings and retained mortgages, respectively, in the accompanying financial statements. Principal payments are allocated to the various classes of each series in the manner specified in the respective offering document. These series may include targeted or planned amortization classes.

10. SUBORDINATED BORROWINGS

	December 31, 1988		December 31, 1987	
Call/Maturity	Balance (dollars in millions)	Effective Interest Rate(1)	Balance (dollars in millions)	Effective Interest Rate(1)
Capital debentures				
1988	$ —	— %	$ 150	9.41%
1989	100	12.70	100	12.70
1995	225	10.95	225	10.95
1991/1996	800	10.18	800	10.18
1996	150	10.27	150	10.27
2016	200	8.42	200	8.42
	1,475		1,625	
Unamortized discount and fees	(140)		(158)	
	1,335		1,467	
Zero coupon capital debentures				
1992	600	13.79	600	13.79
1994	250	13.70	250	13.70
2019	4,600	10.25	4,600	10.25
	5,450		5,450	
Unamortized discount and fees	(4,749)		(4,831)	
	701		619	
Total subordinated borrowings	$ 2,036		$ 2,086	

(1) The effective interest rates above assume interest payments are made on a semiannual basis and are adjusted for the amortization of discounts or premiums, related hedging gains and losses and debt issuance costs, as applicable.

The capital debentures are subordinated to all obligations and liabilities of Freddie Mac including obligations of others that Freddie Mac has guaranteed, whether existing at the date of issuance or thereafter incurred or created. The zero coupon capital debentures rank equally with the capital debentures. The 1991/1996 bonds are redeemable at Freddie Mac's option commencing in 1991 at their face value.

11. CAPITAL STOCK

Preferred Stock

As of December 31, 1987, Freddie Mac had outstanding approximately 15 million shares of non-voting participating preferred stock, $10 par value per share (Existing Preferred Stock). The Existing Preferred Stock could be sold or transferred only to and among FHLB members, approved market makers, Freddie Mac and certain other entities. On July 13, 1988, the Board of Directors decided to permit ownership by the general public of Freddie Mac's preferred stock effective January 1, 1989.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Board of Directors, on August 30, 1988, implemented this decision by authorizing an exchange offer under which Freddie Mac offered holders four shares of a new class of freely transferable senior participating preferred stock, par value $2.50 per share (Senior Preferred Stock), in exchange for each share of the Existing Preferred Stock and a cash capital contribution of $7 per share of Existing Preferred Stock. There are no transfer restrictions applicable to the shares of Senior Preferred Stock. As a result of the exchange offer, at December 31, 1988, 59,917,376 shares of Senior Preferred Stock were issued and 59,910,216 shares were outstanding. Freddie Mac received paid-in capital, net of expenses, of approximately $104 million. The exchange of the Existing Preferred Stock for the Senior Preferred Stock was contingent upon exchanging holders surrendering at least 66⅔ percent of the shares of the outstanding Existing Preferred Stock in accordance with the terms of the exchange offer. Upon issuance of the Senior Preferred Stock, the Existing Preferred Stock held by nonexchanging holders was transformed into Preferred Stock, par value $10 per share, which remains restricted as to transfer. At December 31, 1988, 20,656 shares of the Existing Preferred Stock were transformed and outstanding and remained restricted as to transfer. In connection with the exchange offer, Freddie Mac amended the terms of the Existing Preferred Stock to permit it to redeem each share of Preferred Stock for 3.5 shares of Senior Preferred Stock and require a cash capital contribution of $7 for each share of Preferred Stock so redeemed. On January 25, 1989, Freddie Mac called the Preferred Stock for redemption, effective March 1, 1989.

The Senior Preferred Stock is subject to restrictions on concentration of ownership. The maximum number of shares of Senior Preferred Stock which may be beneficially held by a single person or entity is 2.4 million. However, certain entities that were entitled to hold more than 600,000 shares of the Existing Preferred Stock and that, as a result of the exchange offer, hold more than 2.4 million shares of the Senior Preferred Stock, are entitled to continue holding such excess shares until such time as their beneficial interest falls to 2.4 million shares or fewer.

The Senior Preferred Stock is not redeemable for cash. If Freddie Mac were to issue non-callable common stock, the Senior Preferred Stock would be redeemed for shares of such common stock, unless precluded by law. The Senior Preferred Stock has no conversion or preemptive rights.

Common Stock

Freddie Mac has issued and outstanding 100,000 shares of non-voting common stock. The stock has a par value of $1,000 per share and is held by the Federal Home Loan Banks.

Preference in Dividend Distribution

The Board of Directors may choose to pay dividends on the Senior Preferred Stock without paying dividends on the common stock. The Senior Preferred Stock will be entitled to a dividend preference of the first $10 million of any dividends paid in any calendar year on a non-cumulative basis. After payment of the $10 million preference in any calendar year, the Senior Preferred Stock will be entitled to receive dividends equal to at least $9 for every $1 in dividends paid on the common stock proportionately adjusted for any reduction below 100,000 shares in the number of outstanding shares of common stock.

Preference in Liquidation

In the event of liquidation and after payment of the liabilities of Freddie Mac, the remaining assets of Freddie Mac will be distributed as follows: (1) the holders of the Senior Preferred Stock will receive $2.50

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

per share plus all dividends declared (or required to have been declared) but unpaid; (2) the common stockholders will receive $1,000 per share but not more than, in the aggregate, $100 million; and (3) the holders of the Senior Preferred Stock will then be entitled to receive a further distribution in the aggregate of $9 for every $1 further distributed to the common stockholders, proportionately adjusted for any reduction below 100,000 shares in the number of outstanding shares of common stock.

12. COMMITMENTS

Commitments—Guarantor Program

Under this program, mortgage originators sell mortgages to Freddie Mac at par and, in exchange, simultaneously purchase PCs equal to the unpaid principal balance of the mortgages sold to Freddie Mac.

A summary of outstanding Guarantor program commitments is as follows:

	December 31,			
	1988		1987	
	Amount (dollars in millions)	Basis Point Spread	Amount (dollars in millions)	Basis Point Spread(1)
Mandatory	$2,009	21.8bp	$ 436	19.9bp
Optional	1,075	19.9	1,138	19.9
Outstanding commitments to Guarantor program	$3,084		$1,574	

(1) The 1987 yield has been revised to eliminate the adjustment for the expected value of reinvestment of collections pending disbursement to PC and GMC holders that had been included in prior years.

Commitments to Purchase—Cash Program

Delivery of mortgages under the optional commitment program is at the option of the seller. Delivery is mandatory under all other commitment programs.

A summary of outstanding Cash program purchase commitments is as follows:

	December 31,			
	1988		1987	
	Amount (dollars in millions)	Average Net Yield	Amount (dollars in millions)	Average Net Yield
Mandatory	$1,016	10.21%	$128	10.24%
Optional	16	10.13	586	10.21
Outstanding commitments to purchase-Cash program	$1,032		$714	

Master Commitments

A master commitment is a contract between Freddie Mac and a mortgage lender which sets forth the terms and conditions under which Freddie Mac will purchase mortgages from approved seller/servicers. A master commitment may provide for the purchase of mortgages under one or more purchase programs utilizing various features; e.g., fixed rate, conventional, or FHA/VA. This allows a mortgage lender to quickly tailor transactions throughout the commitment period to changing market conditions.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

A summary of outstanding master commitments is as follows:

	December 31, 1988	December 31, 1987
	(dollars in millions)	
Mandatory	$23,185	$10,198
Optional	12,591	12,906
Outstanding master commitments	$35,776	$23,104

Commitments to Sell—Cash Program

Freddie Mac's PCs are continuously offered for sale under both mandatory and optional delivery programs. Delivery periods range from 10 to 120 days under the mandatory program. Settlements occur a minimum of 140 days and a maximum of 260 days from the date of contract where delivery is at the option of Freddie Mac.

A summary of outstanding commitments to sell under the Cash program is as follows:

	December 31, 1988		1987	
	Amount (dollars in millions)	Average Sales Net Yield	Amount (dollars in millions)	Average Sales Net Yield
Outstanding mandatory commitments to sell-Cash program	$915	10.04%	$539	9.18%

13. INCOME TAXES

Tax legislation eliminated Freddie Mac's exemption from federal income taxes effective January 1, 1985. In order to appropriately reflect the impact of taxation on its financial position, Freddie Mac has identified the items which will result in the primary differences between financial reporting and income tax reporting that arose during pre-taxable years (years of operation from 1970 through 1984) in accounting for certain assets, liabilities, income and expenses. Freddie Mac is presently completing a detailed analysis of these differences in order to quantify the cumulative effect on Freddie Mac's deferred tax liability. This analysis is not sufficiently complete as of this date to support a reasonable determination of the cumulative effect of these transactions on the corporation's deferred tax liability. While these differences between financial reporting and income tax reporting will, to a degree, impact the amount of actual taxes paid in the future, preliminary indications are that these differences will not result in significant additional tax liabilities. The entire tax liability has been shown as a current liability on the accompanying Consolidated Balance Sheets as of December 31, 1988 and 1987. However, Freddie Mac anticipates that, as a result of completing its analysis of transactions in pre-taxable years, a portion of the recorded tax liability may be deferred.

The 1988, 1987 and 1986 tax provisions have been recorded based upon the statutory rate less benefits derived from tax exempt investment income and other items providing permanent tax benefits, resulting in the effective tax rates as shown below.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	Year ended December 31, 1988	1987	1986
	(dollars in millions)		
Provision for income taxes at statutory rate	$188	$192	$203
Permanent tax benefits from investment in tax-advantaged instruments	(15)	(13)	(8)
Actual provision for income taxes	$173	$179	$195
Statutory tax rate	34.0%	40.0%	46.0%
Effective tax rate	31.2%	37.3%	44.1%

14. PENSION PLAN

Freddie Mac has a defined benefit pension plan (the Plan) covering substantially all of its employees. The benefits are based on years of service and the employee's highest compensation over any three consecutive years of employment. Freddie Mac makes periodic contributions to the Plan in amounts that are estimated to adequately fund the present value of all future benefits to current employees and annuitants.

Effective January 1, 1986, Freddie Mac adopted SFAS No. 87, "Employers' Accounting for Pensions." Pension costs and related disclosures for 1988, 1987 and 1986 were determined under the provisions of this SFAS.

The net periodic pension cost of the Plan for 1988, 1987 and 1986 included the following components:

	Year ended December 31, 1988	1987	1986
	(dollars in thousands)		
Service cost-benefits earned during the period	$ 1,742	$ 2,294	$ 1,426
Interest cost on projected benefit obligation	1,532	1,533	1,058
Actual return on plan assets	(523)	(1,154)	(1,483)
Net amortization and deferral	(1,004)	86	457
Net periodic pension cost	$ 1,747	$ 2,759	$ 1,458

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Concluded)

The following table sets forth the Plan's funded status and amounts recognized in Freddie Mac's Consolidated Balance Sheets:

	December 31, 1988	December 31, 1987
	(dollars in thousands)	
Actuarial present value of benefit obligations:		
Vested benefits	$ 7,767	$ 6,294
Non-vested benefits	1,771	1,404
Accumulated benefit obligation	$ 9,538	$ 7,698
Pension Liability:		
Projected benefit obligation for services rendered to date	$ 17,479	$ 14,411
Plan assets at fair value, primarily stocks and U.S. bonds	(19,109)	(15,691)
Funded status	(1,630)	(1,280)
Unrecognized net gain (loss) from past experience different from that assumed and effects of changes in assumptions	1,975	2,869
Unrecognized net asset at date of implementation of SFAS No. 87 being recognized over 17 years	1,821	1,951
Pension liability included in other accrued expenses	$ 2,166	$ 3,540
Major assumptions:		
Weighted average discount rate	9.5%	9.5%
Rate of increase in compensation levels*	6% to 6.5%	6% to 6.5%
Expected long-term rate of return on plan assets	8%	8%

* Range of rates based on employee age.

In addition to providing pension benefits, Freddie Mac provides certain health care benefits for retired employees on a contributory basis. Substantially all of Freddie Mac's employees may become eligible for such benefits if they retire and promptly commence receiving benefits under the Plan.

Freddie Mac offers a Thrift/401(k) Savings Plan to employees who have worked full-time at Freddie Mac for at least one year. Under this plan, employees may contribute from two percent to 12 percent of their annual salaries (not to have exceeded $7,313 in 1988) with Freddie Mac matching employees' contributions to the 401(k) account up to six percent of their salary, depending upon each employee's length of service. Freddie Mac made contributions to this plan of $1.6 million in 1988, $1.3 million in 1987, and $1.0 million in 1986.

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