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The Department of the Treasury

PERFORMANCE & ACCOUNTABILITY REPORT

fiscal year 2008

THE UNITED STATES DEPARTMENT OF THE TREASURY

OUR VISION

Set the global standard in financial and economic leadership

OUR MISSION

Serve the American people and strengthen national security by managing the U.S. Government's finances effectively, promoting economic growth and stability, and ensuring the safety, soundness, and security of the U.S. and international financial systems

OUR VALUES

SERVICE – Work for the benefit of the American people

INTEGRITY – Aspire to the highest levels ethical standards of honesty, trustworthiness, and dependability

EXCELLENCE – Strive to be the best, continuously improve, innovate, and adapt

OBJECTIVITY – Encourage independent views

ACCOUNTABILITY – Responsible for our conduct and work

COMMUNITY – Dedicated to excellent customer service, collaboration, and teamwork while promoting diversity

FISCAL YEAR 2008

PERFORMANCE & ACCOUNTABILITY REPORT

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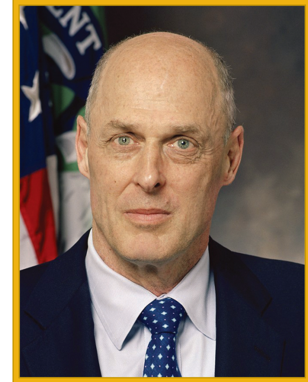
MESSAGE FROM THE SECRETARY



November 17, 2008

On behalf of the Department of the Treasury, I am pleased to submit the Fiscal Year 2008 Performance and Accountability Report. This annual report provides insight into the Department's broad leadership role for the economic and financial activities of the U.S. Government. The current economic turmoil calls for extraordinary measures, and the Treasury Department has actively pursued initiatives aimed at stabilizing the financial system and strengthening financial institutions that play a vital role in supporting U.S. economic activity.

Maintaining and improving the performance of the Department is crucial. In fiscal year 2008, the Department of the Treasury met or exceeded 70 percent of its performance targets, slightly lower than fiscal year 2007. Though the result is lower than the prior year, Treasury improved the quality of its measures through innovative approaches to measure difficult areas, such as Terrorism and Financial Intelligence, and economic and financial technical assistance provided to other countries.

This year brought two additional management challenges for the Department: *Management of Treasury's New Authorities Related to Distressed Financial Markets* and *Regulation of National Banks and Thrifts*. Treasury recognizes the importance of sound stewardship in managing the authorities related to distressed financial markets. We are executing the authorities we have been granted with one primary goal – to restore liquidity and stability to the financial system of the United States. More broadly, we are reviewing the regulation of national banks and thrifts to identify gaps in regulatory authority and the regulatory framework that contributed to the current financial turmoil, and putting forward policies to modernize our financial regulatory architecture to match the evolution of the financial marketplace.

The Department of the Treasury has again received an unqualified opinion on its financial statements. The Department has validated the accuracy, completeness, and reliability of the financial data in this report. Performance data has been validated, and is likewise complete and reliable. The Department has continued to make progress in reducing management control weaknesses and in efforts to satisfy federal financial systems and control objectives.

Sincerely,

Henry M. Paulson, Jr.
Secretary of the Treasury

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ABOUT THIS REPORT

The fiscal year *2008 Treasury Performance and Accountability Report* provides information that enables Congress, the President, and the public to assess the Department's performance relative to its mission and stewardship of the resources entrusted to it.

The magnitude of the economic and financial challenges this year prompted changes in this report. Management's Discussion and Analysis (MD&A) is focused on the contributions Treasury has made on behalf of the American people to mitigate current or potential financial turmoil.

The MD&A also includes key accomplishments and challenges that are summarized by strategic goal, along with trends in performance, budget, and cost. The Performance Highlights page from the prior year has been renamed to *"How Well is Treasury Performing?"* It includes graphical results for Program Assessment Rating Tool (PART) ratings by both number of programs and by funding. Performance measures have two additional rating categories this fiscal year, "exceeded" and "improved." These results are indicated in two charts, one that incorporates baseline and discontinued measures, and one that does not. There is marked difference in viewing the performance results from these two perspectives.

Additionally, the Department has included three new charts. The first chart is a summary of actual performance trends for the last four years. Treasury examined each of its performance measures for favorable or unfavorable trends, and tabulated the results. The second new chart attempts to provide readers with an approximation of the cost of the Treasury Department for each citizen in the United States. Treasury performance cost was divided by an estimate of the U.S. population at the end of fiscal year 2008 to determine the result. The third and final chart plots Treasury performance and cost versus inflation from 2005-2008. This is a dual-axis chart that indicates the year-over-year change in Treasury performance cost and inflation, and the percentage of Treasury performance measures that were either met or exceeded.

The MD&A also includes a new summary of Treasury-wide and Internal Revenue Service specific challenges, and High Risk Area updates (as defined by the Government Accountability Office). Each management challenge is assessed for its progress and status, with hyperlinks to the appendix of the report that will provide additional detail. High Risk areas are summarized, including hyperlinks to the Office of Management and Budget's ExpectMore.gov page for performance information.

The Annual Performance Report includes new performance measure tables that add a percent of target achieved for each performance measure, as well as indicators for actual and target performance trends over the last four years. A new section entitled *"Analysis of Performance Results"* is included to provide a transparent explanation of performance results.

The Department has also included a *"Moving Forward"* section as it has done in previous years to describe what it will do to address any performance shortfalls and future plans.

Treasury believes this report embodies the integrity, objectivity, transparency, and spirit of continuous improvement that is resident at the agency, and clarifies the public benefits of our collective actions.

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The Department of the Treasury

MANAGEMENT'S DISCUSSION & ANALYSIS

PART I

TAB A - Department of the Treasury Materials

INTRODUCTION

Fiscal year 2008 has been a challenging year. The ongoing housing correction has reverberated throughout the U.S. financial system and severely impacted the U.S. economy. Lack of confidence among lenders and strained capital markets have made it harder to obtain student loans, auto loans, home loans and business loans. Restoring confidence in capital markets is essential to the long-term health of the U.S. economy. Treasury has made significant efforts this year to address financial market difficulties and mitigate effects on the overall economy. The list below constitutes some of the actions taken by the Department:

- Led the government response to financial market challenges
- Participated in development and implementation of the *Economic Stimulus Act of 2008*
- Helped homeowners by supporting creation of the HOPE NOW alliance
- Participated in finding solutions for troubled non-depository financial institutions
- Contributed to placement of Fannie Mae and Freddie Mac in conservatorship
- Proposed legislation allowing Treasury to increase liquidity in financial markets
- Implemented measures to bolster regulation of national banks and thrifts
- Established a Temporary Guarantee Program for money market funds
- Released the *Blueprint for a Modernized Financial Regulatory Structure*
- Participated in Federal Housing Administration modernization
- Participated in the development and implementation of temporary tax relief for mortgage holders
- Issued the *Best Practices for Residential Covered Bonds*
- Coordinated the U.S. policy agenda for the U.S.-China Strategic Economic Dialogue

All of these actions are aimed at implementing the Department's strategy to address the four key challenges financial markets face today - confidence, capital, systemic risk and liquidity. It will take time for these actions to have their full effect. Treasury will move aggressively on all possible fronts to address ongoing market and economic challenges.

Treasury's Offices of the Assistant Secretary for Management and Chief Financial Officer, the Deputy CFO, the Deputy Assistant Secretary for Management and Budget, and other Treasury bureaus and policy offices, in coordination with the Office of Financial Stability (OFS), are working through the financial and accounting aspects of the *Emergency Economic Stabilization Act of 2008* (EESA) over which the Department of the Treasury has authority, including the Troubled Asset Relief Program (TARP). The TARP includes a Capital Purchase Program, a Systemically Significant Failing Institutions Program, and may in the future include other programs to purchase troubled assets plus an insurance program as required under EESA.

- Value the various types of assets to be purchased under the TARP's authority
- Model the associated cash flows related to the assets to be purchased under the TARP's authority
- Report the TARP accurately, fairly, and transparently on the OFS's and the Department's financial statements in accordance with Generally Accepted Accounting Principles (GAAP)
- Account for capital infusions and equity positions in publicly traded banks under the Capital Purchase Program
- Account for programs that insure money market funds

Treasury will work with its partners to determine fair market value of the assets it purchases through the TARP program. This work began in early fiscal year 2009. Treasury plans to work closely with the Federal Accounting Standards Advisory Board (FASAB) to ensure that TARP financial reporting maintains consistency with appropriate accounting and financial reporting standards.

While there have been significant accomplishments in fiscal year 2008, much work remains to implement Treasury's new authorities. The Department will exercise proper stewardship and provide exceptional accountability and transparency to perform its work on behalf of the American people. This work is accomplished through Treasury's talented and dedicated workforce.

ORGANIZATION

The Department of the Treasury is the executive agency responsible for promoting economic prosperity and ensuring the financial security of the United States. The Department is organized into two major components, the departmental offices and the bureaus. The departmental offices are primarily responsible for policy formulation, while the bureaus are primarily the operating units of the organization.

Departmental Offices

Domestic Finance advises and assists in areas of domestic finance, banking, and other related economic matters. In addition, this office develops policies and guidance for Treasury Department responsibilities in the areas of financial institutions, federal debt finance, financial regulation, capital markets, financial management, fiscal policy and cash management decisions.

International Affairs advises and assists in the formulation and execution of U.S. international economic, financial, monetary, trade, investment, bilateral aid, environment, debt, development and energy policy, including U.S. participation in international financial institutions.

Terrorism and Financial Intelligence marshals the Department's intelligence and enforcement functions with the twin aims of safeguarding the financial system against illicit use and combating rogue nations, terrorist facilitators, money launderers, drug kingpins, and other national security threats.

Economic Policy reports on current and prospective economic developments and assists in the determination of appropriate economic policies. The office is responsible for the review and analysis of domestic economic issues and developments in the financial markets.

Tax Policy develops and implements tax policies and programs, reviews regulations and rulings to administer the Internal Revenue Code, negotiates tax treaties and provides economic and legal policy analysis for domestic and international tax policy decisions. Tax policy also provides revenue estimates for the President's budget.

Treasurer of the United States advises the Secretary on matters relating to coinage, currency, and the production of other financial instruments. The Treasurer also serves as one of the Department's principal advisors and a spokesperson in the area of financial literacy and education.

The Community Development Financial Institutions Fund (CDFI) expands the capacity of community development financial institutions and community development entities to provide credit, capital, tax credit allocations, and financial services to underserved domestic populations and communities.

The Office of Small and Disadvantaged Business Utilization assists, counsels, and advises small businesses of all types: disadvantaged, women-owned, veteran-owned, service-disabled veteran-owned, and small businesses located in historically

underutilized business zones on procedures for contracting with Treasury.

Internally, the Treasury's Departmental Offices are responsible for the overall management of the Department. The *Office of the Assistant Secretary of Management and Chief Financial Officer* is responsible for internal management and controls. Support organizations include *General Counsel, Legislative Affairs, and Public Affairs*. Also, two inspectors general, the *Treasury Inspector General for Tax Administration and the Office of the Inspector General* provide independent audits, investigations, and oversight to the Department of Treasury and its programs.

Bureaus

Bureaus employ 98 percent of Treasury's workforce and are responsible for carrying out specific operations assigned to the Department.

The Alcohol and Tobacco Tax and Trade Bureau (TTB) collects excise taxes on alcohol, tobacco, and firearms that are lawfully due the government, protects consumers of alcoholic beverages through voluntary compliance programs that are based on education and enforcement to ensure a fair marketplace, and assists industry members in understanding and complying voluntarily with federal tax, product, and marketing requirements.

The Bureau of Engraving and Printing (BEP) designs and manufactures high quality notes and other financial documents that deter counterfeiting and meet customer requirements for quality, quantity, and performance.

The Bureau of the Public Debt (BPD) borrows the money needed to operate the federal government through the sale of marketable, savings, and special purpose U.S. Treasury securities. In addition, it accounts for and services the public debt and provides reimbursable support services to federal agencies.

The Financial Crimes Enforcement Network (FinCEN) safeguards the financial system from the abuses of financial crime, including terrorist financing, money laundering, and other illicit activity.

The Financial Management Service (FMS) provides central payment services to federal program agencies, operates the federal government's collections and deposit systems, provides government-wide accounting and reporting services and manages the collection of delinquent debt owed to the U.S. Government.

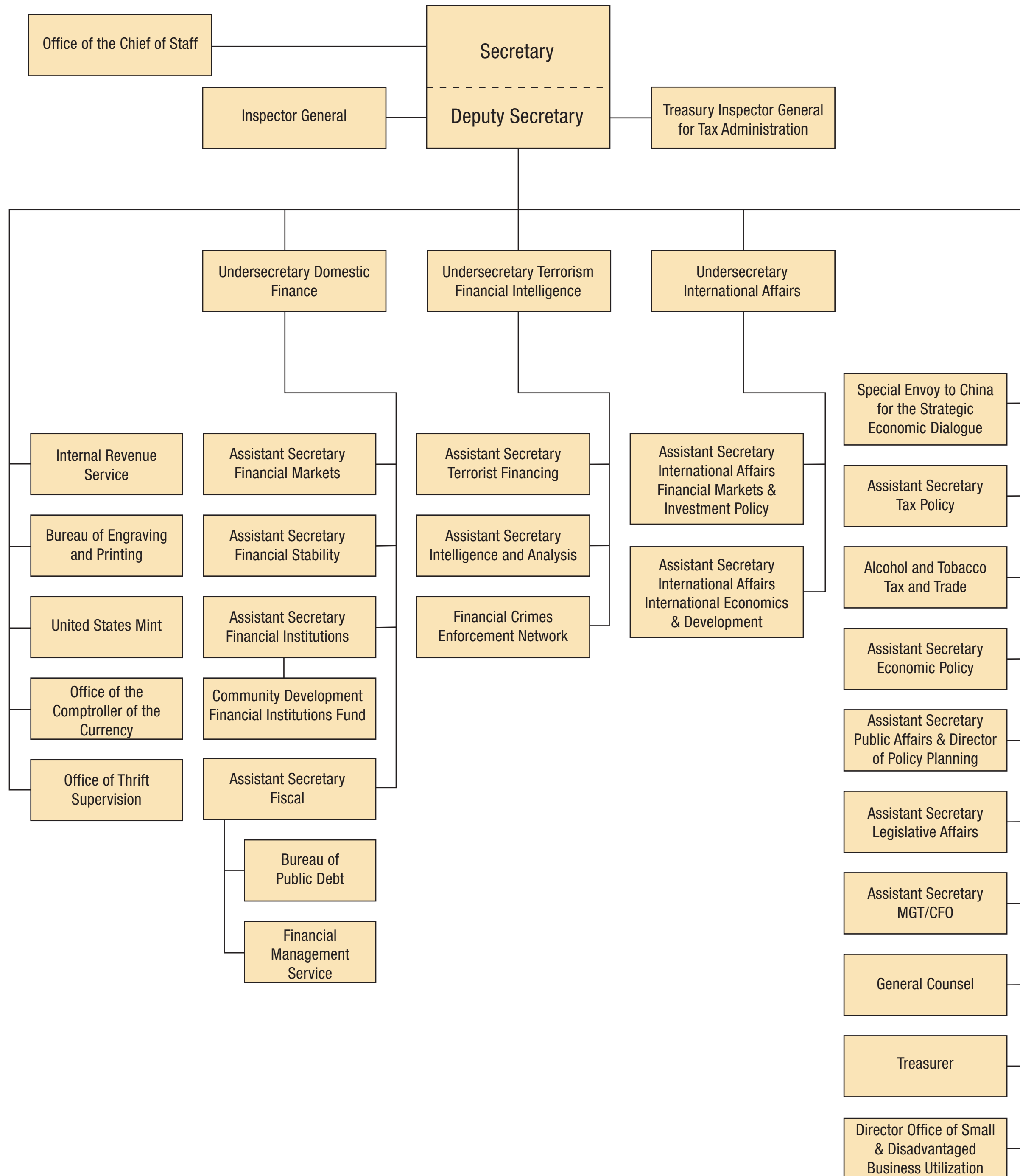
The Internal Revenue Service (IRS) is the largest of the Department's bureaus and determines, assesses, and collects tax revenue for the federal government.

The United States Mint designs, produces, and issues circulating and bullion coins, numismatic coins and other items, Congressional gold medals, and other medals of national significance. The United States Mint maintains physical custody and protection of the nation's gold assets.

The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises national banks to ensure a safe, sound, and competitive banking system that supports citizens, communities, and the economy.

The Office of Thrift Supervision (OTS) charters, examines, supervises, and regulates federal and many state-chartered thrift associations in order to maintain their safety and soundness and compliance with consumer laws.

THE DEPARTMENT OF THE TREASURY ORGANIZATIONAL CHART



THE TREASURY DEPARTMENT'S 2007-2012 STRATEGIC FRAMEWORK

The Treasury Department's *Strategic Framework* is a summary of our goals, objectives, and outcomes. This framework provides the basis for performance planning and continuous improvement.

	Strategic Goals	Strategic Objectives	Value Chains**	Value Chain Outcomes
Financial	Effectively Managed U.S. Government Finances	Available cash resources to operate the government	Collect Disburse Borrow Account Invest	• Revenue collected when due through a fair and uniform application of the law at the lowest possible cost • Timely and accurate payments at the lowest possible cost • Government financing at the lowest possible cost over time • Effective cash management • Accurate, timely, useful, transparent and accessible financial information
Economic	U.S. and World Economies Perform at Full Economic Potential	Improved economic opportunity, mobility and security with robust, real, sustainable economic growth at home and abroad	Strengthen Regulate	• Strong U.S. economic competitiveness • Free trade and investment • Decreased gap in global standard of living • Competitive capital markets • Prevented or mitigated financial and economic crises
		Trust and confidence in U.S. currency worldwide	Manufacture	• Commerce enabled through safe, secure U.S. notes and coins
Security	Prevented Terrorism and Promoted the Nation's Security Through Strengthened International Financial Systems	Pre-empted and neutralized threats to the international financial system and enhanced U.S. national security	Secure	• Removed or reduced threats to national security from terrorism, proliferation of weapons of mass destruction, narcotics trafficking and other criminal activity on the part of rogue regimes, individuals, and their support networks • Safer and more transparent U.S. and international financial systems
Management	Management and Organizational Excellence	Enabled and effective Treasury Department	Manage	• A citizen-centered, results-oriented and strategically aligned organization • Exceptional accountability and transparency

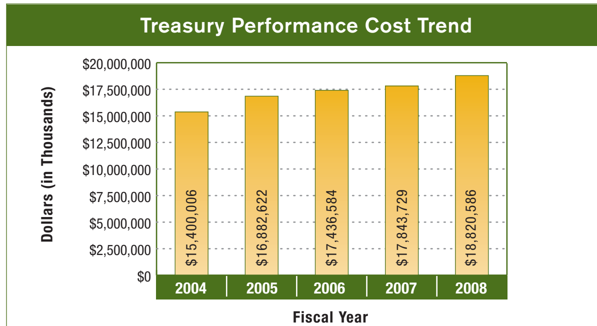
** Value Chains – Programs grouped by a common purpose.

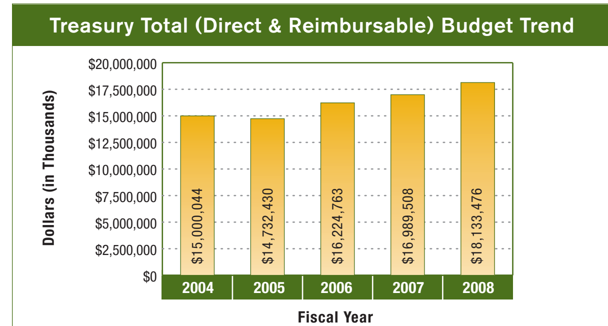
FISCAL YEAR 2008 SUMMARY OF PERFORMANCE BY STRATEGIC GOAL

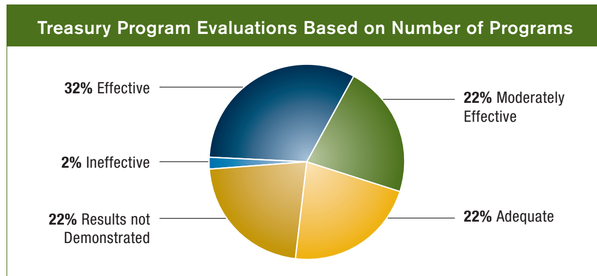
Strategic Goal	Key Accomplishments	Key Challenges	Trend
Effectively Managed U.S. Government Finances **Cost*:** 2007:$13.3 Billion 2008: $14.0 Billion	• Collected $2.74 trillion in tax revenue and $14.6 billion in federal excise taxes on tobacco, alcohol, firearms and ammunition • Processed 98.5 million tax returns electronically, up 10 percent over 2007 • Administered 116.2 million payments under the Economic Stimulus Act of 2008 • Conducted more than 200 auctions resulting in the issuance of more than $5.6 trillion in marketable Treasury securities • Resumed issuance of the 52-week bill on a monthly basis in order to finance budget deficit projections • Reduced the minimum bid at Treasury auctions from $1,000 to $100	• Continue to work toward the Congressional goal of having 80 percent of tax returns filed electronically • Continue to convert from paper to electronic savings bonds • Meet the long-term goal to have 90 percent of payments made electronically • Reduce the use of illegal international tax shelters • Reduce the erroneous payments rate within the Earned Income Tax Credit (EITC) program	Performance ▲ Budget ▲ Cost ▲
U.S. and World Economies Perform at Full Economic Potential **Cost:** 2007: $3.2 Billion 2008: $3.7 Billion	• Participated in development and implementation of the *Economic Stimulus Act of 2008* • Helped homeowners by supporting creation of the HOPE NOW alliance • Participated in finding solutions for troubled non-depository financial institutions • Contributed to placement of Fannie Mae and Freddie Mac in conservatorship • Proposed legislation allowing Treasury to increase liquidity in financial markets • Implemented measures to bolster regulation of national banks and thrifts • Established a Temporary Guarantee Program for money market funds • Released the *Blueprint for a Modernized Financial Regulatory Structure* • Participated in Federal Housing Administration modernization • Participated in the development and implementation of temporary tax relief for mortgage holders • Issued the *Best Practices for Residential Covered Bonds* • Coordinated the U.S. policy agenda for the U.S.-China Strategic Economic Dialogue (U.S.-China SED) • Contributed to reform initiatives at the International Monetary Fund (IMF), World Bank and other international financial institutions • Participated in finalization of proposed rules for U.S. Basel II implementation • Provided loans, investments, financial services and technical support through the CDFI Fund	• Continue to mitigate risks at national banks and thrifts • Restructure regulatory institutions to improve supervision of financial markets • Reform Medicare and Social Security to ensure long-term solvency • Maintain open economies despite rising protectionist interests • Improve productivity management relating to the printing and engraving of currency notes • Improve supply management for bullion coin production • Manage cost issues related to the penny and nickel	Performance ▶ Budget ▲ Cost ▲
Prevented Terrorism and Promoted the Nation's Security Through Strengthened International Financial Systems **Cost:** 2007: $537 Million 2008: $555 Million	• Persuaded a number of the world's leading financial institutions of the risks of dealing with Iran and Iranian banks • Designated and blocked key Zimbabwe regime supporters • Completed actions targeted at the Revolutionary Armed Forces of Columbia (FARC) • Led efforts within the Financial Action Task Force (FATF) • Increased collaboration within the Intelligence Community • Implemented efforts to increase Bank Secrecy Act (BSA) effectiveness and efficiency	• Fully implement anti-money laundering and counter-terrorist financing (AML/CFT) laws in key countries • Establish an external validation process to justify performance results	Performance ▲ Budget ▲ Cost ▲
Management and Organizational Excellence **Cost:** 2007: $763 Million 2008: $508 Million	• Issued 179 audits reports that produced financial accomplishments of $2.4 billion • Provided integrity and fraud awareness presentations to more than 90,000 IRS employees and educated tax professionals by providing awareness presentations to tax practitioners and preparers • Created the Office of Privacy and Treasury Records (PTR) • Established two Human Capital performance measures	• Improve security configuration management • Provide effective corporate leadership and accountability to improve performance between corporate, bureau, and program office management • Complete an increased number of Material Loss Reviews (MLRs) • Remain at last year's levels for the President's Management Agenda (PMA) Initiatives	Performance ▶ Budget ▼ Cost ▼

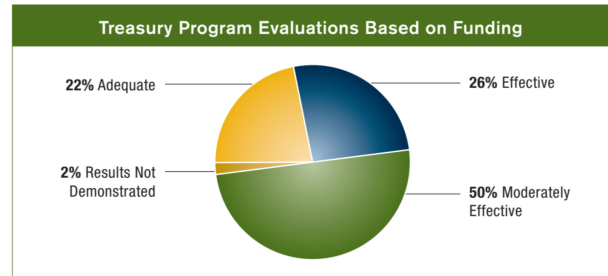
* Cost is stated as "Performance Cost", and represents imputed costs, depreciation, losses, and other expenses not requiring budgetary resources. A full definition can be found in the Introduction to Part 2.

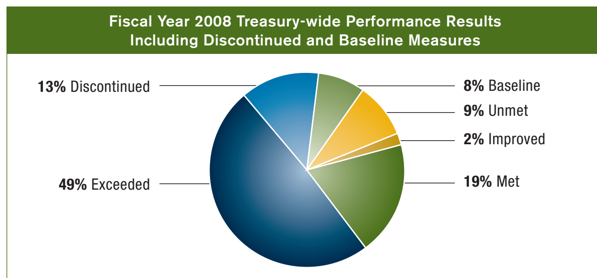
HOW WELL IS TREASURY PERFORMING?

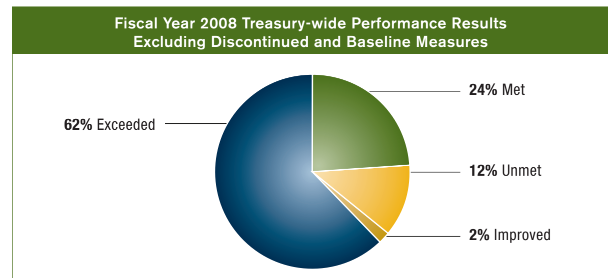


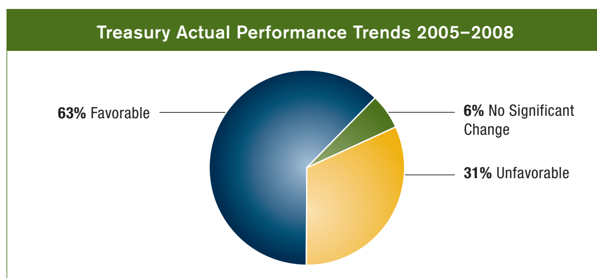


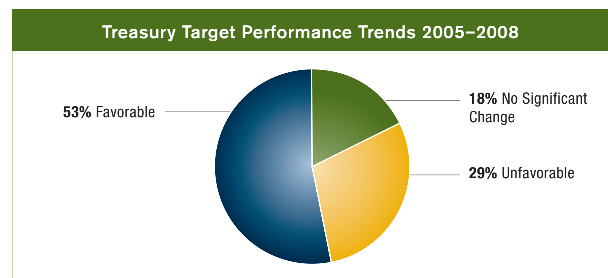


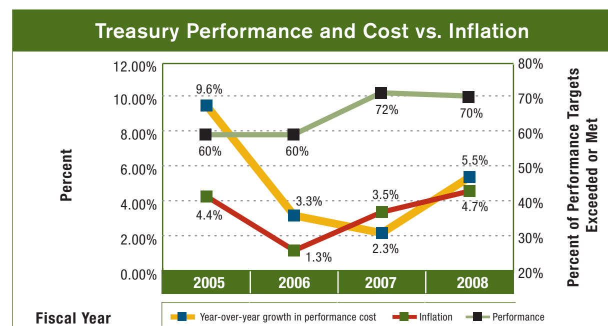












HOW WELL IS TREASURY PERFORMING DISCUSSION

Performance Cost and Budget Trends

Performance cost represents the best indication of the total cost to operate the Treasury Department. It includes normal operating expenses as well as imputed costs, depreciation, losses, and other expenses not requiring budgetary resources. Performance cost on the average has risen four to five percent per year since 2004. The Department's total budget, which includes direct appropriations and reimbursable amounts, has also risen an average of four to five percent per year since 2004.

Program Evaluations

A total of 37 of Treasury Department programs have been evaluated using the Office of Management and Budget's Program Assessment Rating Tool (PART) since 2002. Each program receives a rating of effective, moderately effective, adequate, results not demonstrated, or ineffective. Results for all program evaluations are shown in two different charts. One chart is based on the number of programs, and the other on program funding. Programs receiving an adequate or better rating were 76 percent using the number of programs, but 98 percent based on program funding.

Performance to Target

In fiscal year 2008, the Treasury Department revised its performance rating system. Performance to target was rated as exceeded, met, improved from the prior year (but not met), unmet, baseline or discontinued. Prior to this, performance measures were rated only as met or unmet. Results are shown in two charts, one including all performance measures, and one not including baseline and discontinued measures. While 70 percent of targets were exceeded, met or improved based on all measures, 88 percent of targets were exceeded, met or improved based on measures that were not base-lined or discontinued.

Actual and Target Performance Trends

Trends in actual performance and targets have been analyzed since 2004 where data was available. Trends can move upward, downward, or remain flat. Depending on the type of measure, a trend can be favorable, unfavorable, or remain unchanged. Results indicate that 63 percent of actual performance trends were favorable, 31 percent were unfavorable, and 6 percent were unchanged. Target trends were 53 percent favorable, 29 percent unfavorable, and 18 percent unchanged.

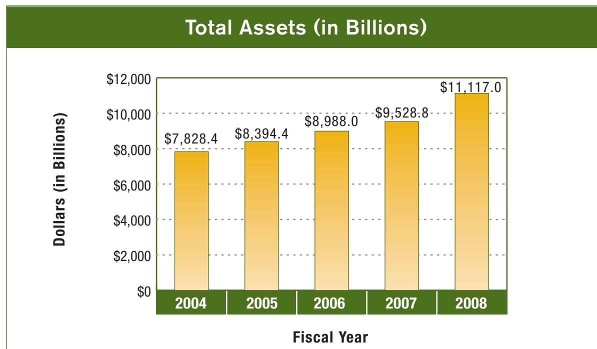
Treasury Cost per Person

A chart that indicates the approximate cost of the Treasury Department per person in the United States is shown here. The calculation is determined by dividing Treasury Performance Cost by an estimate of the U.S. population at the end off fiscal year 2008. This ratio attempts to describe the cost of the Department in terms people can relate to.

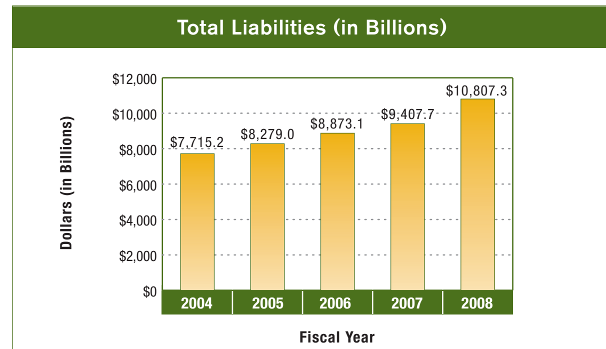
Treasury Performance and Cost versus Inflation

A dual scale chart provides Treasury performance to target, performance cost, and inflation information since fiscal year 2004. The data indicate that the gap between Treasury Performance Cost and inflation is narrowing while performance has improved.

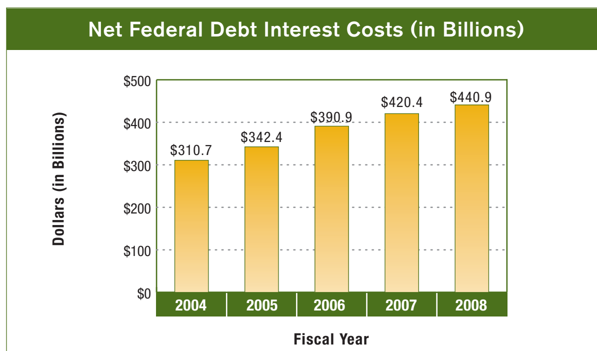
FINANCIAL HIGHLIGHTS



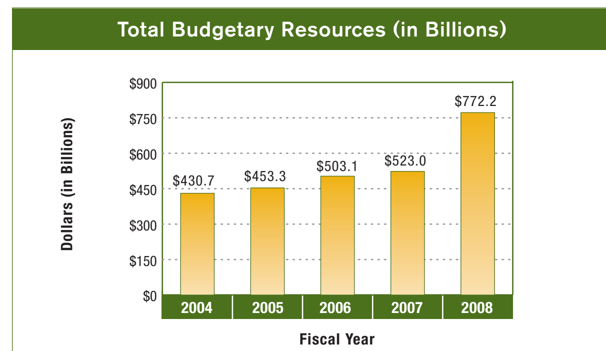
The increase of $1.6 trillion in total assets in fiscal year 2008 is largely due to the increase in future funds required from the General Fund of the U.S. Government to pay for the federal debt owed to the public and other federal agencies.



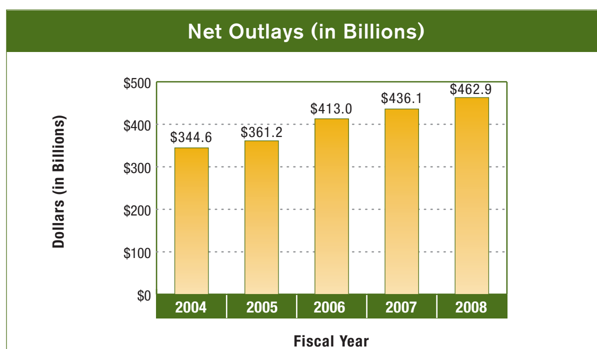
Total liabilities increased by $1.4 trillion from fiscal year 2007 to fiscal year 2008. The majority of the increase is due to borrowings from other federal agencies and debt issued to the public.



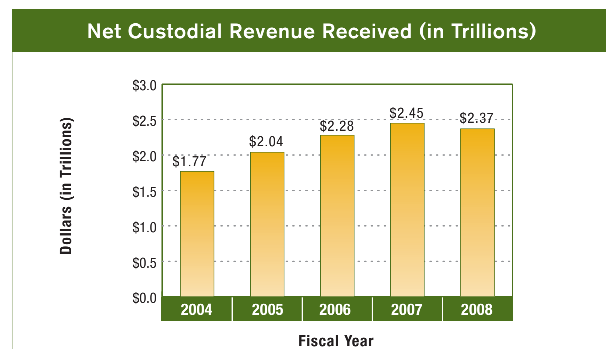
The increase of $20.5 billion in net interest paid on the federal debt is due to the increase in the debt. Total federal debt and interest payable increased by $1.05 trillion in fiscal year 2008.



The majority of the increase in total budgetary resources for fiscal year 2008 was to ensure liquidity of Government-Sponsored Enterprises (GSEs) pursuant to the *Housing and Economic Recovery Act of 2008*.



The majority of the $26.8 billion increase in net outlays was due to the increase in interest payments on the federal debt.



Total custodial revenue collected on behalf of the U.S. Government decreased by $82 billion. The majority of the decrease can be attributed to the Economic Stimulus payments of $93.4 billion issued by the Internal Revenue Service.

FISCAL YEAR 2008 KEY INITIATIVES

LED GOVERNMENT RESPONSE TO FINANCIAL MARKET CHALLENGES

Throughout fiscal year 2008, the Treasury Department coordinated with federal agencies, state authorities, international bodies and private groups to address challenges in financial markets and the broader economy. Some examples include:

- Coordinated government mortgage management initiatives with the Department of Housing and Urban Development (HUD)
- Developed funding solutions for economically distressed industries with the Department of Commerce
- Developed alternative funding solutions for student loan programs with the Department of Education
- Coordinated international financial negotiations with the Department of State
- Collaborated with the Financial Stability Forum (FSF), a body consisting of representatives from the world's largest economies and international financial institutions, and G-7 countries to develop international guidelines for managing financial market challenges
- Worked with various state authorities to address mortgage origination issues and concerns about conditions at state-chartered financial institutions

For financial market management in particular, the Department worked with members of the President's Working Group on Financial Markets (PWG), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA) and other agencies to respond to market events.

Established in 1988, the PWG is the federal government's primary inter-agency committee responsible for coordinating supervision of financial markets and is comprised of:

- The Secretary of the Treasury, who serves as Chairman
- The Chairman of the Board of Governors of the Federal Reserve
- The Chairman of the Securities and Exchange Commission (SEC)
- The Chairman of the Commodities Futures Trading Commission (CFTC)

In August 2007, the President charged the PWG with reviewing the underlying causes of financial market turmoil. In response, the PWG issued a *Policy Statement on Financial Market Developments* in March 2008 providing both an overview of causes as well as specific policy recommendations to address regulatory and management shortfalls. The key recommendations to government authorities and market participants to address market weaknesses include:

- Reforming key parts of the mortgage origination process in the U.S.
- Enhancing disclosure and improving the practices of sponsors, underwriters, and investors with respect to securitized credits
- Reforming the credit rating agencies' processes for and practices regarding rating structured credit products
- Ensuring that global financial institutions take appropriate steps to address weaknesses in risk management and reporting practices
- Ensuring that prudential regulatory policies applicable to banks and securities firms, including capital and disclosure requirements, provide strong incentives for effective risk management practices

The report includes 27 specific recommendations for public and private sector action within these broad categories. The PWG issued a detailed report on progress in October 2008 and is continuing to monitor the implementation of recommendations.

The Treasury Department, as the nation's foremost economic policy agency, will continue to take necessary steps to address financial market challenges in coordination with public and private sector agencies.

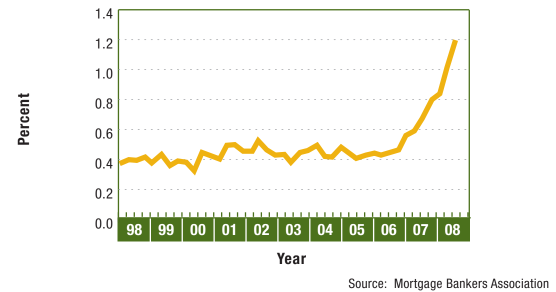
DEVELOPED AND IMPLEMENTED THE ECONOMIC STIMULUS ACT OF 2008

The *Economic Stimulus Act of 2008* was signed into law on February 13, 2008. Created to support the economy during a period of slowing growth, the bill provided relief in the form of individual tax rebates for households and tax incentives for businesses to stimulate investment. Businesses were expected to utilize $45 billion in tax deductions by the end of 2008. In fiscal year 2008, over 116.2 million stimulus payments, totaling $94.3 billion, were issued in the form of checks and electronic deposits.

The Department participated directly in development and implementation of the stimulus package. The IRS and FMS managed customer inquiries and issued payments during the tax season. In particular, the IRS provided informational announcements and mailings, interactive telephone options, an online payment calculator, and maintained a hotline to allow taxpayers to check on the status of their payment. The FMS issued 74.1 million paper checks and made over 42 million electronic deposits. Some additional statistics on the stimulus payments:

- The first stimulus payments were made by electronic deposit 75 days after the legislation was passed
- A total of 132.9 million notices were sent to inform taxpayers of their potential eligibility
- 5.5 million operator-assisted calls and 21.9 million automated calls were handled, resulting in a 90 percent increase in total telephone demand
- 38.7 million taxpayers used the *"Where's My Stimulus Payment?"* webpage to check the status of their payment
- $1.46 billion in delinquent non-tax, state tax, and child support debts were withheld from stimulus payments and disbursed to appropriate recipients

Additional information may be found here: *Stimulus Payment*



SUPPORTED THE HOPE NOW ALLIANCE

Ongoing challenges in housing markets have increased pressure on homeowners unable to make their mortgage payments. Seeking to support a coordinated response to the crisis, the Department participated in discussions with mortgage industry participants in August 2007 to search for a solution to address market conditions. The result was the formation in October 2007 of the HOPE NOW Alliance, a private sector alliance of mortgage servicers, counselors, and investors to provide information and direct assistance to homeowners to help avoid preventable foreclosures.

HOPE NOW has worked aggressively over the past year to disseminate information to at-risk homeowners through direct mailings, advertisements, and phone contacts. They have also actively coordinated matching at-risk homeowners with mortgage industry specialists to find best solutions. In December 2007, HOPE NOW adopted the mortgage management framework developed by the American Securitization Forum, and in February 2008 adopted Project Lifeline to focus efforts as efficiently as possible to help at-risk homeowners. As of August 2008, HOPE NOW included 94 percent of mortgage servicers and had helped over two million homeowners negotiate arrangements enabling them to avoid foreclosure and keep their homes.

The success of the HOPE NOW Alliance is encouraging in light of the ongoing difficulties in mortgage markets.

The Treasury Department will continue to work closely with lenders and key industry participants to identify aggressive strategies to help at-risk homeowners.

Additional information may be found here: *HOPE NOW*

SOLUTIONS FOR NON-DEPOSITORY INSTITUTIONS

Working in coordination with the Federal Reserve and SEC, Treasury participated in negotiations during fiscal year 2008 to determine an appropriate course to address financial difficulties at some of the country's largest non-depository financial institutions. Challenging conditions in financial markets, particularly linked to rapidly falling values of Mortgage Backed Securities or MBS (securities issued with mortgages as collateral), asset-backed commercial paper (short-term securities generally linked to revenue streams, such as payments of auto loans or credit cards), credit default swaps (similar to insurance policies on debt in case of default) and other instruments increased financial pressures on institutions with large holdings of these assets. Failure of a few large institutions with significant market presence threatened to severely impact market confidence. To ensure confidence in capital markets, extraordinary consultations and actions were taken to address conditions in financial institutions such as Bear Stearns, Lehman Brothers, and American International Group. The Department will continue to monitor financial conditions and respond as necessary to maintain the health of the financial system.

CONTRIBUTED TO PLACEMENT OF FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP

On July 30th 2008, President Bush signed the *Housing and Economic Recovery Act of 2008* into law, granting the Treasury Department, the Federal Reserve and the new Federal Housing Finance Agency (FHFA) authority to enhance stability in financial markets and manage affairs related to the two largest sources of mortgage finance, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Among the new authorities given to the FHFA was the ability to bring the two government-sponsored enterprises (GSEs) under either conservatorship (allowing FHFA to assume the powers of the GSEs' directors, officers, and shareholders without declaring bankruptcy) or receivership (allowing FHFA to assume the powers above and initiate liquidation). The Act also granted the Secretary of the Treasury temporary authority to purchase GSE obligations and securities through December 31, 2009.

Following passage of the legislation, financial markets, business conditions, and the current financial condition of the two GSEs were closely monitored. On September 7, 2008 the Treasury Department, Federal Reserve, and FHFA deemed it necessary for the preservation of market stability and taxpayer interests to place Fannie Mae and Freddie Mac in conservatorship under the July 2008 Act.

From the beginning of the current financial turmoil, the Treasury Department has maintained three critical objectives: provide stability to financial markets, support the availability of mortgage finance, and protect taxpayers. The intent of placing the GSEs under conservatorship was to minimize the near-term costs of insolvency at the two institutions and initiate resolution of systemic risks associated with the GSEs' structure. The steps taken were the result of detailed and thorough collaboration between FHFA, Treasury, and the Federal Reserve.

The Preferred Stock Purchase Agreements reached between Treasury and the two GSEs included the following provisions:

- For each GSE, the Treasury Department received $1 billion in Senior Preferred Equity Shares, providing an annual dividend of 10 percent and permitting the Department to receive dividends before all other shareholders
- The Treasury received warrants (ownership options) for 79.9 percent of each enterprise
- The Department committed to provide each GSE up to $100 billion under a secured lending facility to ensure solvency

- The Department committed to purchase up to $5 billion in MBS issued by the GSEs

Fannie Mae and Freddie Mac's continued activity is central to recovery in the housing market and mitigation of underlying financial market uncertainty. The temporary liquidity and capital backstops included in the conservatorship arrangements are aimed at providing longer-term clarity to investors in GSE debt and MBS and ensuring the stability of financial markets. Fannie Mae and Freddie Mac continue to play an important role in financing mortgages in capital markets.

PROPOSED LEGISLATION ALLOWING TREASURY TO INCREASE LIQUIDITY IN FINANCIAL MARKETS

On September 19, 2008, the Treasury Secretary, Federal Reserve Chairman, and SEC Chairman met with Congressional leaders to discuss legislation permitting Treasury to increase liquidity in financial markets by purchasing up to $700 billion in assets from financial institutions. The initiative was primarily intended to ensure stability in financial markets and improve financial institutions' capital position to encourage new lending. On the same day, the Department also announced expansion of the existing program to purchase GSE MBS.

The *Emergency Economic Stabilization Act of 2008* was signed into law on October 3, 2008. The legislation included provisions for an expanded MBS purchase program, a whole loan purchase program, a troubled-assets insurance program, and an equity purchase program. Under the Act, Treasury was provided authority to purchase up to $250 billion in securities, with an additional $100 billion available upon written certification to Congress by the President and a final $350 billion available upon written request by the President, subject to disapproval by Congress. The law provides a series of safeguards to protect taxpayer interests, including the establishment of two oversight boards and a Special Inspector General; requirements that participants provide the government an ownership stake in their business and restrict certain payments to their executives; and strict provisions on asset manager selection.

IMPLEMENTED MEASURES TO BOLSTER REGULATION OF NATIONAL BANKS AND THRIFTS

The OCC and OTS are the primary regulators of national banks and thrifts, respectively. With elevated concerns about banking solvency given strained financial markets, both have made extensive efforts to monitor evolving conditions at the financial institutions they regulate and implement measures to ensure the stability of the banking system. The Inspector General has indicated regulation of national banks and thrifts as a *Management Challenge* for fiscal year 2008.

In fiscal year 2008, 14 financial institutions with $216 billion in deposits were placed into receivership under FDIC authority. Of these, five were national banks, three were thrifts, and six were state banks. The bulk of deposits were held by two thrifts, Washington Mutual Bank and IndyMac Bank, which accounted together for $207 billion in deposits. Work-out solutions, whereby some or all deposits and assets were assumed by another existing bank, were arranged by FDIC and regulators for all failed institutions except IndyMac Bank. IndyMac Bank was placed under conservatorship and operations were assumed directly by FDIC under a newly-formed IndyMac Federal Bank.

Supervisory activities at OCC and OTS during fiscal year 2008 centered on evaluation of loan holdings and risk management practices to identify existing and potential weaknesses. In response to the crisis, supervisory efforts have been strengthened in key risk areas, including: underwriting and credit administration, diversification of funding sources (including realistic contingency funding planning), development of strong internal controls and risk management systems, timely recognition of losses, and maintenance of strong capital positions. Over the past year, resident examiner teams from the OCC have been in place at the largest national banks to monitor their funding, trading, and mortgage practices as well as gather information on market conditions, deal flow, and funding availability.

Information obtained by the examiners contributed to early identification of problem areas and development of risk management practices that have been implemented by the PWG, the Senior Supervisors Group, and the FSF. (The Senior Supervisors Group consists of supervisory agencies from France, Germany, Switzerland, Britain, and the U.S.)

Given increases in leveraged lending at national banks in prior years, the OCC undertook in-depth leveraged lending reviews at the largest national banks in fiscal year 2008, looking specifically at banks' syndicated pipeline management, stress testing, and limit setting. Following the reviews, a *Leveraged Lending* handbook was developed based on findings and issued to all banks, consolidating and supplementing guidance to bankers and examiners on managing leverage risk. At an inter-agency level, both the OCC and OTS have worked directly with the Federal Reserve and FDIC to review large syndicated loans through the Shared National Credit program. The comprehensive review in 2008 of these loans covered 8,750 credit facilities with commitments of over $2.8 trillion. The OCC and OTS will continue to coordinate their licensing and supervisory procedures with other federal agencies to keep regulations current, transparent, and supportive of financial industry stability and growth.

Due to the thrift industry's natural concentration in longer-term mortgages (thrifts are required to keep 65 percent of their holdings in mortgages), the OTS maintains a Net Portfolio Value model which provides estimates of each institution's interest rate risk. The model allows the OTS to value a wide range of financial instruments and produce reports focusing on areas such as net interest income, liquidity, and value-at-risk. Enhancements to the Net Portfolio Value model were added in 2008 which improve examiners' ability to track interest rate risk and permit for easier electronic filing (E-Filing) of applications for actions requiring OTS approval.

To facilitate management of mortgage concerns, the OCC and OTS have encouraged banks and thrifts to work constructively with borrowers facing difficulty meeting their mortgage obligations. This includes support for industry initiatives such as the HOPE NOW alliance and the American Securitization Forum as well as outreach efforts with advocacy groups, research organizations, community development practitioners, and community development membership organizations. During fiscal year 2008, the OCC published guides for homeowners on ways to recognize and avoid foreclosure rescue fraud and effectively manage certain hybrid adjustable rate mortgages. The OTS has issued additional guidance to thrifts governing regulation of late charges, prepayment penalties, and adjustments to mortgage terms. Given the high concentration of mortgage holdings at thrifts, the OTS has actively encouraged utilization of foreclosure-prevention strategies, including loan modifications, conversion of adjustable-rate mortgages into fixed-rate mortgages, extension of amortization, and payment deferral.

Although national banks were not dominant originators of subprime mortgages, strains in housing markets have significantly affected banks' residential mortgage and home equity loan portfolios. In response, the OCC began requiring the nine largest national bank servicers, accounting for 90 percent of mortgages held by national banks and 40 percent of mortgages overall, to submit comprehensive mortgage data on a monthly basis. Similarly, in July 2008 the OTS published its first *Mortgage Metrics Report*, presenting key performance data on first lien residential mortgages serviced by the top five thrifts or their affiliates, covering 91 percent of thrift mortgages. The data showed a total of 49,044 loss mitigation actions through the end of March, providing solutions for 25 percent of thrift loans in foreclosure. In September, the two supervisors merged their reports into a single *Mortgage Metrics Report*, covering some 35 million mortgages worth $6.1 trillion, constituting an important data source on conditions in mortgage markets.

Given more stringent regulation and the conditions in mortgage markets, additional concern has more recently been directed towards the under-provision of credit in financial markets. The 2008 OCC *Annual Survey of Credit Underwriting Practices* showed that banks have substantially tightened underwriting standards for both retail and commercial loans over the last year. Regulatory guidance issued to banks and thrifts by both OCC and OTS has

reiterated the importance of maintaining prudent credit underwriting standards throughout the economic cycle.

ESTABLISHED A TEMPORARY GUARANTEE PROGRAM FOR MONEY MARKET FUNDS

On September 19, Treasury announced a Temporary Guarantee Program for money market funds. Taxable and tax-exempt funds regulated by the SEC under the *Investment Company Act of 1940* are eligible to participate in the guarantee program upon payment of an assessed fee of 0.01 percent of net asset value per share greater than or equal to $0.9975 as of September 19. Funds with net asset value per share less than $0.9975 and greater than or equal to $0.995 are required to pay an upfront fee of 0.015 percent, based on the number of shares outstanding as of September 19. Funds with net asset values below $0.995 were not eligible to participate. In return for participation, fund shareholders receive a guarantee that they will be compensated up to the $1 share price of the fund should the share price fall below $0.995. Initial funding of $50 billion for the program was provided through the Exchange Stabilization Fund established under the *Gold Reserve Act of 1934*.

The Temporary Guarantee Program is a temporary measure intended to address short-term dislocations in credit markets. The program will exist for an initial three month term, after which the Secretary of the Treasury will review the need and terms for program extension. The Secretary has the option to renew the program through September 18, 2009. The program will not automatically extend for the full year and money market funds would be required to renew their participation to maintain coverage. If the Secretary does not renew the program at the end of the three month period, the program will terminate.

RELEASED THE *BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE*

Recent capital market developments stemming from the subprime mortgage and credit turmoil have exposed the need for fundamental reform of the U.S. financial regulatory system. Created over 70 years ago, the U.S. financial regulatory structure today is managed under segregated industry "silos" that have failed to keep pace with industry changes. Under this structure, regulators have narrow responsibilities to supervise activities within their industry but little responsibility to regulate across industries. With the development of more integrated financial markets that are characterized by convergence of industries, interconnectedness, and globalization, this "siloed" structure has permitted substantial gaps and redundancies in oversight. To respond to these conditions, the Department issued a *Blueprint for a Modernized Financial Regulatory Structure* in March 2008 to identify and propose solutions to address major shortfalls in regulatory systems. The *Blueprint* provides a series of near, intermediate, and long-term recommendations to restructure the U.S. financial regulatory system.

Near-term recommendations:

- Modernize the PWG by expanding its membership to include the heads of the OCC, OTS, and FDIC, enabling the body to serve as coordinator of financial regulatory policy for the entire financial industry
- Establish a federal Mortgage Origination Commission to develop national standards for mortgage origination and work to ensure compliance by all mortgage originators
- Improve Federal Reserve liquidity provisions with respect to non-depository financial institutions

Intermediate-term recommendations:

- Transition financial institutions chartered as thrifts into national bank charters and merge the OTS into the OCC

- Establish one federal regulator of state banks, in contrast to the dual supervisory system splitting regulatory responsibility between the Federal Reserve and FDIC
- Establish a federal charter for payment and settlement systems supervised by the Federal Reserve
- Establish a federal charter and oversight board for insurance companies, distinct from state insurance licensing
- Merge the CFTC with the SEC, while retaining key strengths of each institution

Long-term recommendations

- Restructure the existing financial regulatory system into a three-tiered system with duties divided by objectives, including:
  - A market stability regulator, likely the Federal Reserve, which would supervise overall conditions in financial markets and develop measures to address high-level market stability
  - A prudential financial regulator, which would be responsible for assessing risk management at all financial institutions and supervising institutions' safety and soundness associated with government guarantees
  - A business conduct regulator, which would establish standards for business practices for financial institutions and ensure protection of consumer rights
- In addition to these agencies, two other regulatory bodies were proposed:
  - A federal insurance guarantor, which would provide insurance services for the entire financial sector, similar to services currently provided to banks by the FDIC
  - A corporate finance regulator, which would oversee corporate finance in public securities markets, similar to services currently provided by the SEC

No amount of regulation can fully eliminate capital market risks, but it is clear that a modernized regulatory structure is essential to establishing a more stable financial system, protecting consumer interests, and promoting financial market competitiveness.

Additional information may be found here: *Blueprint for a Modernized Financial Regulatory Structure*

PARTICIPATED IN FEDERAL HOUSING ADMINISTRATION MODERNIZATION AND PROVISION OF TEMPORARY TAX RELIEF FOR HOMEOWNERS

In addition to GSE reform, two other presidential initiatives were announced in August 2007 to address problems in mortgage markets: expanding the capacity of the Federal Housing Administration (FHA) to provide mortgage assistance to a greater range of homeowners and providing temporary tax relief for homeowners entering foreclosure or negotiating partial mortgage write-downs.

The Department worked closely with HUD to promote passage of FHA-related statutes in the *Housing and Economic Recovery Act of 2008*. Among other provisions, the legislation expanded FHA's authority to provide assistance to homeowners by offering government insurance to lenders who voluntarily reduce mortgages for at-risk homeowners to at least 90 percent of the property's current value. (Also known as the Hope for Homeowners program.) To participate in the program, homeowners are required to share a portion of the appreciation of the value of their homes with the FHA. A board consisting of the Secretary of HUD, the Secretary of the Treasury, the Chairman of the Federal Reserve, and the Chairman of FDIC was established under the legislation to oversee implementation of the program. The new measures, which came into effect on October 1, 2008, are expected to help an additional 400,000 homeowners refinance into more affordable mortgages.

In addition to the Hope for Homeowners program, the FHASecure program has helped approximately 360,000 homeowners since July 2007 refinance into FHA-insured loans. The program provides assistance to homeowners with conforming loans (prime loans valued up to $417,000) who are unable to afford mortgage payments

after the reset of their adjustable rate mortgage. Starting in July 2008, FHASecure also began providing assistance to subprime borrowers with adjustable rate mortgages who have missed up to three monthly mortgage payments over the previous 12 months or experienced temporary economic hardship. The Department was directly involved in promoting FHASecure and supported the extension of benefits to additional homeowners.

In December 2007, the *Mortgage Forgiveness Debt Relief Act of 2007* was passed providing temporary tax relief for homeowners entering foreclosure or negotiating partial mortgage write-downs. Generally, debt that is forgiven by a lender is included as income for tax purposes. The Act permits homeowners to refinance their mortgages and pay no federal taxes on forgiven debt if the refinance occurs during 2007, 2008, or 2009. An estimated $200 million in tax forgiveness is projected to be available to homeowners under the legislation. The Treasury Department, through the IRS, OCC, and OTS, has encouraged homeowners with mortgage problems to take full advantage of the tax relief.

Additional information may be found here: *Mortgage Forgiveness Debt Relief Act*

ISSUED THE *BEST PRACTICES FOR RESIDENTIAL COVERED BONDS*

The availability of affordable mortgage financing is essential to a healthy economy. Along with focusing on restoring the traditional sources of mortgage financing in 2008, the Treasury Department took steps to encourage development of new sources for mortgage funding and strengthen financial institutions by issuing a *Best Practices for Residential Covered Bonds*. In preparing this guidance, the Department consulted with European counterparts as well as the FDIC, Federal Reserve, OCC, OTS, SEC, and various market participants.

Covered bonds provide a means for issuing commercial banks or thrifts to sell off rights to mortgage payments made by borrowers without selling the mortgages themselves. In current practice, a large percentage of mortgages are originated by banks or thrifts and then sold to an entity which creates MBS which are then sold to investors. In these transactions, ownership of the mortgage is effectively transferred from the mortgage originator to the bond holder and the mortgage originator has no liability if the mortgage is not paid. With covered bonds, the originator of the mortgage is required to place the mortgages on its books, making them liable for payments if the mortgage borrower does not pay. Additionally, as the mortgage remains on the originator's books, the originator is also required to keep capital reserves covering the mortgages. Covered bonds are currently used to finance mortgages in the United Kingdom and Europe, constituting a $3.3 trillion market, and are a promising source of mortgage financing to complement the existing system in the U.S.

On July 15, 2008, the FDIC issued the *Final Covered Bond Policy Statement* which specified actions that the FDIC will take if a covered bond issuer becomes insolvent or is placed into receivership. The *Best Practices for Residential Covered Bonds* is a complement to the FDIC statement by introducing quality standards in areas such as collateral and disclosure. In conjunction with the release of the guidance, the Treasury Department updated its policy to include covered bonds as an approved asset category for Treasury's investments and deposits of public money with commercial counterparties, which will provide credibility for the asset class.

The $11 trillion U.S. mortgage market can benefit from all forms of mortgage finance. As Treasury seeks to encourage new sources of mortgage funding in the United States, improve underwriting standards, and strengthen financial institutions' balance sheets, covered bonds can help provide additional funding to homeowners and strengthen U.S. financial institutions by diversifying risk. America's four largest banks, Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo, have announced plans to establish covered bond programs to launch the market in the United States.

Additional information may be found here: *Best Practices for Residential Covered Bonds*

U.S.–CHINA STRATEGIC ECONOMIC DIALOGUE

Initiated in 2006, the U.S.-China SED is a semiannual forum bringing together the two countries' highest-level officials to discuss key economic issues. The intent is to improve officials' understanding of the interests and challenges faced by their counterparts on issues of relevance to both economies, to improve policy coordination on areas of mutual interest, and to institutionalize a forum for addressing sensitive issues. Since its inception, the U.S.-China SED has held four full meetings with discussions on issues including management of financial and macroeconomic cycles, market access, trade, property rights protection, food and product quality, financial regulation, energy management, environmental policy, and other issues. The latest U.S.-China SED was held in Annapolis, Maryland in June 2008.

As the coordinator for the U.S. Government, the Department of the Treasury has worked closely with other agencies in the federal government to develop meeting agendas, establish policy goals, and facilitate implementation of final agreements. Key achievements during the December 2007 and June 2008 meetings included:

- Launching negotiations for a bilateral investment treaty to help open new opportunities for U.S. and Chinese investors
- Signing of a Ten-Year Energy and Environment Cooperation Framework focused on creating a new energy-efficient model for sustainable economic development
- Reaching agreements to further open financial markets in the areas of banking, insurance, and securities
- Expanding coordination on management of product quality and food safety
- Expanding efforts to address economic imbalances related to trade, investment, and exchange rates
- Establishing guidelines to improve transparency in administrative rule-making and innovation policy

By establishing this dialogue, both sides have committed to addressing potentially sensitive economic issues of interest in a central forum. Through the U.S.-China SED, the two countries' officials have reached important policy decisions and established relationships building mutual trust and promoting improved coordination. The fifth U.S.-China SED is scheduled to be held in Beijing, China in December 2008.

Additional information may be found here: *U.S.-China SED*

FISCAL YEAR 2008 PERFORMANCE BY STRATEGIC GOAL

EFFECTIVELY MANAGED U.S. GOVERNMENT FINANCES

Tax returns filed electronically

In fiscal year 2008, a total of 98.5 million tax returns were filed electronically, a 10 percent increase over 2007. Although the Department has not yet reached the Congressional goal of having 80 percent of tax returns filed electronically, in fiscal year 2008 the Department achieved 63 percent for individual taxpayers including taxpayers who filed solely to claim the economic stimulus. Treasury continues to promote the use of the IRS Free File program as a means of increasing E-Filing. A recent survey showed that 96 percent of those who used the Free File program found it easy to use, 98 percent said that they would recommend it to others, and 95 percent said that they would use it again.

Increase electronic payments

In fiscal year 2008, the Department issued 116.2 million economic stimulus payments. However, only 36.2 percent were made electronically. Overall, 79 percent of Treasury payments and associated information were made electronically. Treasury continues to promote the use of direct deposit for government payments through the Go Direct campaign. There were 901,054 conversions from paper checks to direct deposit during the third year of the campaign. This is an increase over the 510,045 conversions during the campaign's second year. The total number of conversions since the inception of the campaign is over 2.1 million for a return on investment of $184.7 million.

Debt financing

Debt financing operations are critical to ensuring that the government has the money needed to continue its operations. In fiscal year 2008, the Department conducted more than 200 auctions, resulting in the issuance of over $5.6 trillion in marketable securities. Treasury successfully resumed the issuance of the 52-week bill on a monthly basis in order to meet increased demand for borrowing. Additionally, the minimum bid at Treasury auctions was reduced from $1,000 to $100 to broaden the potential investor pool

Saving bonds

Issuing savings bonds is an important aspect of debt financing and the Department is committed to offering them in an efficient manner. There are approximately $700 billion in paper savings bonds outstanding. Going forward, Treasury is encouraging its customers to purchase and manage their holdings online using TreasuryDirect. TreasuryDirect allows customers to buy savings bonds and convert paper bonds to an electronic version, increasing efficiency in management and servicing of bonds over the long-term. To mitigate risks associated with online financial transactions, Treasury continually seeks ways to increase security. For example, TreasuryDirect Access Cards are distributed to account holders, providing a unique and secure means to access their accounts. While the website remains the primary means of communicating with the public about Treasury securities, outreach through other channels, such as financial literacy programs, will target customers unaccustomed to conducting transactions online. Although a date has not been set for the withdrawal of paper bonds from sale, the intent is to move investors to TreasuryDirect as the preferred way to buy and hold savings bonds.

Need to address international tax issues

The Treasury Department is working to improve international tax administration to effectively deal with increased tax issues associated with globalization for both individual and corporate taxpayers. In fiscal year 2008, Treasury issued guidance addressing offshore and cross-border compliance risks. Collaboration with foreign tax administrators was expanded by the addition of Japan's National Tax Agency to the Joint International Tax Shelter Information Centre, an organization created by the tax agencies of the U.S., Britain, Canada, and Australia to identify and curb abusive cross-border transactions and schemes. The Treasury Department has tax representatives in ten international

cities, and in fiscal year 2009 tax representatives will be placed in Beijing, China.

Need to address high rates of erroneous payments

The Department continues to have high rates of erroneous payments within the EITC program, however, improvements in 2008 allowed for removal of the long-standing EITC *Federal Managers' Financial Integrity Act of 1982* (FMFIA) Material Weakness. In fiscal year 2008, as part of the effort to complete the *Study of Universal Use of Advanced Payment of Earned Income Credit* mandated by Congress, Treasury took several steps to address the issue. These steps included improving communication with taxpayers and tax practitioners, reaching out to employers to gain their insights into the benefits, costs, risks, and barriers if the EITC program were expanded, and enhancing the training of examiners reviewing EITC returns. In fiscal year 2008, $3.2 billion in revenue was protected through examination of returns claiming the EITC credit and document matching programs.

U.S. AND WORLD ECONOMIES PERFORM AT FULL ECONOMIC POTENTIAL

Contributed to reforms at the IMF, World Bank, and other international institutions

In fiscal year 2008, the Department was actively involved in reforms at international financial institutions. One of the more outstanding achievements was reform at the IMF. Based on the Department's recommendation, the IMF has restructured its voting system to expand participation for emerging market countries, coordinated development of investment guidelines for sovereign wealth funds, and undertaken management reorganization saving some $100 million in annual expenses. With these changes, the IMF is redefining its role in international markets to better match global exchange and investment needs.

Banking regulators finalized U.S. Basel II rules

In November 2007, federal banking regulators (the Federal Reserve, FDIC, OCC, and OTS) reached final agreement on U.S. rules implementing the Basel II Capital Accord. The agencies issued a notice of proposed rulemaking in July 2008 and are expected to implement final rules in 2009. The new provisions effectively marry banks' internal risk management systems with their capital requirements, more directly linking asset risks with cash holdings. In addition to the standard Basel II rules, the proposed U.S. rules preserve two requirements from current U.S. regulations — a conforming leverage ratio and prompt corrective action requirements — to maintain consistency in supervisory quality. Implementation of the rules is required for the country's ten largest banks. Other banks are currently permitted to implement the new rules on an optional basis and will otherwise continue to be subject to previous capital requirement regulations.

Provided loans, investments, financial services, and technical support through the CDFI Fund

The CDFI Fund provides capital, loans, and tax credits to specialized financial institutions that finance economic development in underserved communities. The Fund competitively awards amounts to organizations that offer a wide array of banking services, including loans, investments, and financial education to underserved populations and communities. The Fund also provides incentives for community development by allocating federal tax credits to organizations that attract investors for commercial, retail, industrial, and mixed-use development projects. These organizations sell these credits to investors, which can be applied against federal income taxes, in order to generate funds for projects in target markets. Investments associated with the CDFI Fund contributed to the creation or maintenance of 29,539 jobs in fiscal year 2008, surpassing the program target of 28,676 jobs.

Market conditions complicate efforts to mitigate risks at national banks and thrifts

Current market conditions can be attributed in part to poor risk management practices at financial institutions and insufficient government regulation of lending activities. While the vast majority of national banks and thrifts remain well capitalized, there are some which remain over-exposed to riskier mortgage assets or highly leveraged

investments. Over the past year, the OCC and OTS have made pointed efforts to work with national banks and thrifts to reduce exposure to risky assets and improve risk management, as outlined previously in the *Key Initiatives* section. However, current strained markets for some products, and over-exposure by some institutions to softer regional markets, have complicated efforts to manage these risk exposures. Assets with uncertain valuations remain on financial institutions' books – removing them will require time and effective risk management. Deleveraging, as banks reduce holdings in certain assets, has also incurred substantial costs. Until these assets can be removed from institutions' balance sheets, new lending will remain constrained. The OCC and OTS will continue to work with national banks and thrifts to isolate risky investments and work towards developing strategies to limit exposure to future losses.

Incomplete regulatory restructuring of the financial system

The current "siloed" system of regulatory oversight in the United States is incompatible with financial markets characterized by cross-sector convergence and market globalization. Many of the recent problems in financial markets have stemmed from a confusing and sometimes insufficient mix of state and federal financial regulations, lack of appreciation for the growing complexity of cross-sector financial transactions and institutions, and lack of understanding of the riskiness of certain investments. Issuing the *Blueprint for a Modernized Financial Regulatory Structure* in March 2008 capped the Department's analytical review of the financial system. Included in the report are a series of near, intermediate, and long-term measures to improve regulatory oversight and restructure the "siloed" system. Common across these measures is a recognized need to establish stronger federal oversight of mortgage origination, insurance practices, clearing operations, and banking regulation. These policy recommendations are outlined previously in the *Key Initiatives* section. As of the end of fiscal year 2008, most recommendations from the *Blueprint* had yet to be implemented.

Incomplete reforms of Medicare and Social Security

The financial conditions of Medicare and Social Security remain dire. Based on actuarial assumptions published in March 2008, the Medicare Hospital Insurance trust fund is projected to begin paying out more in expenditures than it receives in taxes and dedicated revenues by the end of 2008. With the deficit between expenditures and revenue expected to continue rising, the fund is expected to be exhausted by 2019. Under current assumptions, Social Security is similarly projected to begin paying out more in benefits than it receives in income and payroll taxes in 2011, with the fund exhausted by 2041. The current actuarial deficit to cover all expected future payments for Social Security recipients is $13.6 trillion. (The actuarial deficit is the required funding needed today to pay for the existing liabilities of all current contributors and recipients.) In addition, the Medicare Supplementary Medical Insurance program that covers prescription drug benefits is projected to require general revenue financing that will grow faster than the economy and beneficiary incomes. These budgetary shortfalls will require policy action to ensure the solvency of the two funds and manageable provision of prescription drug benefits. Given the Secretary's position as Chairman of the Boards of Trustees for the Social Security and Medicare trust funds, in fiscal year 2008 the Department issued five articles offering policy recommendations to address funding problems at the two funds. Government action on these recommendations, however, was limited during 2008, due to significant attention directed at immediate financial challenges.

Protectionist interests impede the ability to maintain open economies

Preservation of open international trade and financial channels has become more challenging in today's economic environment. Collapse of the Doha Round talks in July 2008, heightened concerns about investments by sovereign wealth funds and foreign government-owned enterprises and delayed consideration of the U.S.-Colombia Free Trade Agreement highlight these challenges. The Treasury Department supports the expansion of trade and investment opportunities which can promote economic development and security. While the number of U.S. free

trade agreements negotiated with Treasury Department input increased in 2008, delayed implementation of these agreements has limited their benefit for the U.S. economy. The Department will continue to actively participate in the U.S. Government's efforts to open access to foreign markets and promote trade and investment growth.

Improve productivity management relating to the printing and engraving of currency notes

The manufacturing of currency notes experienced a 0.6 billion unit (7.2 percent) reduction in quantity ordered by the Federal Reserve, a drop from 8.3 billion notes in 2007 to 7.7 billion in 2008. This reduction in the Federal Reserve order was large enough to affect a 12 percent drop in BEP's productivity between fiscal years 2007 and 2008.

Improve supply management for bullion coin production

As the economy and financial markets softened, investors sought the perceived safety of precious metals. Revenue from the sale of gold, platinum, and silver bullion coins more than doubled, increasing to $949 million in fiscal year 2008 from $356 million in fiscal year 2007. However, successful sales efforts in the bullion product line posed a new set of challenges. The volume of precious metal blanks suppliers were able to provide on time and production capacity limits at the Mint constrained the number of bullion products that could be produced. These forces compelled the Mint to temporarily suspend sale of certain bullion coins as production was unable to meet demand.

Manage cost issues related to the penny and nickel

For the third year in a row, the penny and nickel cost more to produce than their face value. Two primary factors affected the cost to produce these coins. First, the slowing economy reduced demand for circulating coins, increasing the fixed production cost per unit. Shipments from the Mint to the Federal Reserve fell from 15.4 billion coins in 2007 to 8.6 billion in 2008. Second, global price increases for copper, nickel, and zinc, the metals used to produce the penny and nickel, drove up per unit production costs. Between September 2004 and September 2008, spot prices for copper, nickel, and zinc increased by 141.5 percent, 34 percent, and 78 percent, respectively. The Department is working with Congress to determine more cost-effective ways to produce circulating coins in the future.

PREVENTED TERRORISM AND PROMOTED THE NATION'S SECURITY THROUGH STRENGTHENED INTERNATIONAL FINANCIAL SYSTEMS

Persuaded a number of the world's leading financial institutions of the risks of dealing with Iran and Iranian banks

A precautionary advisory and an online warning were issued to U.S. banks about the risks of doing business with Iran. Specific attention focused on the Central Bank of Iran which has engaged in deceptive financial conduct, including requesting that its name be removed from global transactions to make it more difficult for intermediary financial institutions to determine the true parties in the transaction. Simultaneously, Treasury continued to take targeted financial actions against Iranian individuals and entities engaged in Iran's proliferation activities or support to terrorist groups. Bank Melli, Iran's largest bank, was designated for providing services to entities involved in Iran's nuclear and ballistic missile programs, including entities listed by the United Nations for their involvement in those programs. Bank Mellat was designated for providing bank services in support of Iran's nuclear entities. A vast majority of the world's leading financial institutions have dramatically scaled back or completely cut off their dealings with Iran and its banks as a result of mutually reinforcing actions taken by government and private sector entities. These actions helped protect the integrity of the financial system from illicit conduct while supporting a multilateral effort to reach a negotiated solution on Iran's nuclear program.

Designated and blocked key Zimbabwe regime supporters

In January 2008, OFAC designated two Zimbabwean entities and two individuals as part of an increased effort to pressure those who are aiding Robert Mugabe's efforts to cripple Zimbabwe. In July 2008, the President signed

a new Executive Order to expand sanctions against the Government of Zimbabwe and significantly enhanced OFAC's ability to designate additional individuals and entities. This included entities owned or controlled by the Government of Zimbabwe or an official of the Government, or those that have participated in human rights abuses. OFAC designated 17 entities including several working with their government in an unofficial capacity. Designations included one individual whose support for Robert Mugabe's regime contributed to the undermining of democratic processes and institutions in Zimbabwe.

Completed actions against FARC

The *Foreign Narcotics Designation Kingpin Act* gives Treasury the authority to apply economic sanctions against foreign narcotics trafficking worldwide. In fiscal year 2008, Treasury designated 15 key commanders of FARC leadership, parts of the FARC's money laundering network, senior Venezuelan officials supporting the FARC, and members of the FARC's international committee. According to a federal indictment, FARC is responsible for 60 percent of the cocaine that is brought into the United States, and is directly involved with its production and distribution. Four successive actions throughout the year focused on disrupting FARC's money laundering operations through the international financial system. These actions are part of an ongoing U.S. Government effort under this Act to apply financial measures against foreign drug kingpins.

Led efforts within the Financial Action Task Force (FATF)

Critical to Treasury's strategic goal of preventing terrorism and strengthening national security is identifying systemic vulnerabilities that terrorist and other criminals can exploit to finance their operations and interests. Treasury led or co-chaired several important working groups within the FATF that produced valuable guidance and reports for identifying and addressing these vulnerabilities in the international financial system, including Iran, Pakistan, Sao Tome and Principe, Turkmenistan, Uzbekistan, and the northern part of Cyprus. As a result, the FATF issued public statements expressing concern and alerting jurisdictions worldwide to the risks arising from the deficiencies in those anti-money laundering/counter-terrorist financing (AML/CFT) regimes.

Increased collaboration with Intelligence Community

Treasury enhanced its efforts to provide timely, accurate, actionable, and policy-relevant intelligence analysis on the financial underpinnings of threats to national security. This analysis took the form of tactical and strategic assessments to inform policymaking and support enforcement actions. The Department strengthened relationships with its Intelligence Community counterparts and other partners in fiscal year 2008 through exchanges and assignments at the working level. Treasury hosted representatives from the National Security Agency, the Defense Intelligence Agency, United States Central Command, and other key partners to improve coordination. Treasury liaison officers participate in rotations within the Intelligence Community in the United States and overseas.

Implemented efforts to increase Bank Secrecy Act effectiveness and efficiency

Treasury placed additional emphasis on providing guidance and feedback to regulated industries, engaging specific financial institutions and industries to learn more about the practical implications of regulatory requirements, and providing additional feedback to industry. A proposal was announced to significantly simplify the requirements for depository institutions to exempt their eligible customers from Currency Transaction Reporting. In fiscal year 2008, the draft rule on Chapter 10 was published, an effort to overhaul Bank Secrecy Act regulations for inclusion in the new Code of Federal Regulations, to provide greater clarity in regulations and make it easier for industry to follow, as well as more intuitive and responsive to industry feedback. This simplified approach serves as an important factor of the Department's anti-money laundering mission by facilitating compliance by financial institutions. Additionally, the Department worked collaboratively with other federal banking agencies to assess different approaches to examinations that are commensurate with risk.

Need to fully implement AML/CFT laws in key countries

As a leader and representative of the Financial Action Task Force (FATF), the Department is responsible for encouraging countries to comply with international AML/CFT standards. Using these standards to determine compliance, FATF assessed 37 countries in fiscal year 2008 and the Department served as an assessor to 12 of these mutual evaluations. Despite Treasury's work, there is still room for improvement in implementing these laws in key countries. In particular, Pakistan has passed an anti-money laundering law, but has yet to implement it. Additionally, many Gulf countries have yet to adequately protect against vulnerabilities from cash courier systems.

Need to implement a mechanism for validating performance results

A composite performance measure was developed to rate the impact of activities related to the Department's efforts to prevent terrorism and safeguard U.S. and international financial systems. Determining this impact has proved to be extremely difficult; currently the only validation is from internal customers and the Department. An external validation process needs to be determined.

MANAGEMENT AND ORGANIZATIONAL EXCELLENCE

Issued audit reports

TIGTA conducted audits and investigations to ensure fair administration of the nation's tax system and accountability for more than $2 trillion in tax revenue collected each year. The audits conducted identify high-risk issues and deficiencies related to the administration of programs and operations. These audits ensure that taxpayers are served appropriately and their rights adequately protected. In fiscal year 2008, TIGTA issued 179 audit reports, making recommendations to improve areas such as tax compliance, security maintenance, systems, and operations, resulting in $2.4 billion in potential financial benefits.

Enhance security of information technology

The Treasury Department strives to provide a secure information technology infrastructure. Treasury strengthened its networks by encrypting 99.8 percent of laptops, 99.7 percent of digital assistants, testing 98 percent of system contingency plans, certifying and accrediting 97 percent of systems, strengthening security policies, and implementing enhanced safeguards to reduce exposure to Internet-based threats. However, the Department did not meet its goal of 100 percent compliance with Security Configuration requirements.

The Department recognizes the importance of cyber security in fulfilling its mission. In fiscal year 2008, Treasury made significant progress in strengthening security configuration management, which was noted as a significant deficiency in fiscal year 2007. The Federal Information Security Management Act (FISMA) 2008 audit found no significant deficiencies in information security, and the Department's remaining material weakness in this area was formally closed.

Created the Privacy and Treasury Records office

Treasury is committed to maintaining, collecting, using, and disseminating information necessary to carry out its mission. PTR was created to strengthen the Department's privacy program and records management. PTR will ensure that Treasury has a system in place to serve and inform the public, and strengthen the Department's compliance with privacy and disclosure requirements.

Developed human capital measures

In fiscal year 2008, the Department developed two human capital performance measures. The first measure is designed to assess progress in developing a high-performance, talented, and diverse workforce; the second measure is designed to assess Treasury's standing as a highly desirable employer of choice.

Strengthen corporate leadership

The Treasury Department has made a profound effort in 2008 to promote corporate governance. In addition to daily meetings of the senior leadership team, weekly bureau head meetings, and monthly Treasury-wide council meet-

ings, the Department has taken several actions to improve corporate management. An Executive Review Board was re-established for major IT capital investments to better engage department and bureau executive leadership in IT decision making.

The Human Capital Strategic Plan was revised, identifying the factors that will shape the future workforce environment of the agency, and the corporate strategies that are needed to meet these challenges. A corporate approach to procurement provided significant savings and improved governance, communication, and training across the agency. A prototype Treasury performance scorecard was developed for the financial outcomes described in the Department's strategic plan.

Corporate governance activities were consistently monitored and any gaps in the process were identified. These included strategic planning, financial management, asset management, information technology, risk management, human capital, procurement, performance management, privacy and records management, and emergency/continuity program management.

Material Loss Reviews

OIG is mandated to conduct MLRs of any Treasury-regulated bank failures resulting in material losses greater than $25 million or two percent of the institution's assets. An MLR examines the cause(s) of the failure, the supervision exercised over the institution, and recommendations regulators can consider to help prevent future failures. Also examined are indicators of fraud that may lead to the criminal or civil prosecution of the perpetrators. In fiscal year 2008, OIG completed one MLR of the NetBank failure and currently has five MLRs in progress.

President's Management Agenda

The PMA is a management initiative instituted in 2001 to improve management practices across the federal government and transform it into a results-oriented, efficient, and citizen-centered enterprise. The PMA is used as a framework to strengthen Treasury's workforce, lower the cost of doing business through competition, improve financial performance, increase the use of information technology and E-Government capabilities, and integrate budget decisions with performance data. Fiscal year 2008 results were similar to fiscal year 2007. Progress steadily improved throughout the year in the areas of E-Government, Performance Improvement, and Human Capital. For additional information see the *Treasury website*.

President's Management Agenda

Initiative	Status				FY 2008 Progress			
	FY 2005	FY 2006	FY 2007	FY 2008	Q1	Q2	Q3	Q4
Human Capital	Y	G	G	G	G	G	G	G
Commercial Services	G	G	Y	Y	Y	Y	Y	Y
Financial Performance	R	R	Y	Y	Y	Y	G	G
E-Government	R	Y	Y	Y	G	G	G	G
Performance Improvement	Y	Y	Y	Y	G	G	G	G
Improper Payments	R	R	R	R	Y	Y	Y	Y
Credit Management	N/A	N/A	Y	Y	Y	G	G	G

G Green for Success Y Yellow for Mixed Results R Red for Unsatisfactory

SUMMARY OF MANAGEMENT CHALLENGES AND HIGH-RISK AREAS

TREASURY-WIDE MANAGEMENT CHALLENGES

Management Challenge	Importance	Progress	Status
Management of Treasury's Authorities Related to Distressed Financial Markets	Protection of the taxpayer from unnecessary risk associated with the implementation of the program	New	New
Regulation of National Banks and Thrifts	Prevent or better mitigate unsafe and unsound practices and protect the financial health of the banking industry	New	New
Corporate Management	Overall agency performance/improved value for the taxpayer	Reasonable	Adequate
Management of Capital Investments	Effective use of taxpayer funds for large capital investments	Significant	Meets Expectations
Information Security	Appropriate protection of electronic information and cyber assets	Significant	Meets Expectations
Linking Resources to Results	Resources that are focused on producing the best value for stakeholders	A cost accounting policy revision and changes to operations allowed removal of this challenge	Closed
Anti-Money Laundering and Terrorist Financing/BSA Reporting	U.S. and international financial systems that are safe	Reasonable	Meets Expectations

IRS MANAGEMENT CHALLENGES

Management Challenge	Importance	Progress	Status
Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems	Improved taxpayer service and efficiency of operations	Reasonable	Meets Expectations
Tax Compliance Initiatives	Improved compliance and fairness in the application of the tax laws	Reasonable	Meets Expectations
Security of the Internal Revenue Service	Appropriate protection of financial, personal, and other information	Reasonable	Meets Expectations
Providing Quality Taxpayer Service Operations	Improved taxpayer service	Significant	Exceeds Expectations
Human Capital	Enables the IRS to achieve its mission	Significant	Exceeds Expectations
Erroneous and Improper Payments	Effective use of taxpayer funds	Reasonable	Adequate
Taxpayer Protection and Rights	Fairness in the application of the tax laws	Significant	Meets Expectations
Processing Returns and Implementing Tax Law Changes During the Tax Filing Season	Improved taxpayer service and efficiency of operations	Significant	Exceeds Expectations
Using Performance and Financial Information for Program and Budget Decisions	Resources that are focused on producing the best value for stakeholders	Significant	Exceeds Expectations

Click on any management challenge for additional information.

Progress Rating	Description
New	A new management challenge in fiscal year 2008
None	No progress was made on the management challenge
Marginal	Minimal progress was made on the management challenge compared to the prior year
Reasonable	Progress was made in addressing the management challenge, improving from the prior year
Significant	A large amount of progress was made compared to the prior year assessment

Status Rating	Description
New	A new management challenge in fiscal year 2008
Inadequate	Regardless of progress made in the fiscal year, the status of the management challenge remains incomplete and falls significantly short of expectations
Adequate	The current status of the management challenge is acceptable but falls slightly short of expectations set for the fiscal year
Meets Expectations	The current status of the management challenge meets expectations set for the fiscal year
Exceeds Expectations	The current status of the management challenge exceeds expectations set for the fiscal year
Closed	Actions taken resulted in the elimination of the management challenge

HIGH RISK AREA UPDATE: ENFORCEMENT OF THE TAX LAWS

Challenges/Actions

Reduce the opportunity for evasion

- Propose legislation changes targeted at information reporting, compliance by businesses, and strengthening tax administration.

Target specific areas of noncompliance and improve voluntary compliance with extensive research.

- In fiscal year 2008 compliance studies will be completed on S corporations and individuals; in fiscal year 2009 updates to the payment and filing compliance estimates of the tax gap will be completed.
- Research the effect of service and its relationship to taxpayer compliance. In addition, survey taxpayers to see the relationship between complexity, burden, and compliance to improve workload selection formulas and reduce the burden of unnecessary taxpayer contacts.
- Assess outreach and education awareness campaigns that target the EITC eligible and noncompliant population, and adjust as necessary to increase participation and improve compliance. In fiscal year 2008 significant achievements were made: 1) established diagnostic measures for compliance, outreach, and support, 2) developed full cost computation for EITC compliance activities, 3) increased protected revenue from the under-reporter program by 190 percent, 4) increased base compliance activities by 35 percent, 5) reduced the no-change rate on examination cases by 59 percent, 6) realized a return on investment in compliance activities of 12–to-1 for examinations and 67-to-1 for under-reporter cases. In fiscal year 2009, activities from the fourth year of the EITC Return Preparer Study will be completed and short-term outcomes will be analyzed, including penalties and accuracy of returns, and the effect of due diligence visits, education/compliance notices, and phone calls to first-time EITC preparers.

Improve information technology through modernization.

- Execute the following initiatives: In fiscal year 2008 and fiscal year 2009 the process to match information documents to information on a tax return and improved case selection and scoring will be reengineered. In fiscal year 2009 data storage facilities will be enhanced to improve the workload identification. In fiscal year 2009 automated lien delivery will be deployed. In fiscal year 2009 new and improved analytics will be developed that identify issues and select cases for all types of audits. By fiscal year 2009 features will be built and implemented for an electronic transmission capability for additional tax forms on Modernized electronic Filing (MeF). In fiscal year 2009 the Broker Compliance Initiative pilot will be used to identify and address tax schemes of individuals and businesses.

For additional information, click here: *Enforcement of Tax Laws*

HIGH RISK AREA UPDATE: IRS BUSINESS SYSTEMS MODERNIZATION

Problem: The Business Systems Modernization (BSM) program is developing and delivering a number of modernized systems to replace the aging business and tax processing systems currently in use. This effort is highly complex and scheduled to be carried out over a numbers of years, ultimately creating a more efficient and effective IRS. Though the IRS experienced delays and cost overruns in the early years of the effort, improved practices and oversight are now contributing to better delivery of outcomes.

Goal: Meet all BSM project milestones within a cost and schedule variance of 10 percent of the initial estimate.

Challenges/Actions

Fully implement all projects and programs for the Business Systems Modernization program.

- Customer Account Data Engine (CADE) will hold over 200 million individual and business taxpayer's information that will provide flexibility to respond quickly to complex tax law and policy initiatives. Through mid-August 2008 CADE processed 30.5 million individual tax returns which is 21 percent of all individual tax returns filed. Each new release of CADE will expand the functionality CADE can process and thus increase the numbers of returns processed. Under current resource assumptions, IRS has a goal of processing over 90 percent of all returns through CADE by Fall 2012.
- Make similar progress on all other BSM projects: Accounts Management Services (AMS) applies applications that enable IRS employees and taxpayers to access, validate, and update taxpayer accounts on demand. Modernized E-File (MeF) will allow the IRS to store all tax return data in a modernized tax return database allowing all viewers to see an entire tax return online. Custodial Detail Database (CDDB) provides detailed data to support revenue financial reporting. Revenue Accounting Control System (RACS) will reduce the risk of failure to sustain future clean IRS audit opinions, and streamline financial reporting.

For additional information, click here: *IRS BSM*

ANALYSIS OF FINANCIAL STATEMENTS

The complete financial statements and auditor's report are in part III of this report.

CONDENSED CONSOLIDATED BALANCE SHEETS (in Millions):	**2008**	**2007**
Due From the General Fund	$ 10,100,763	$ 9,052,624
Other Intra-governmental Assets	551,115	322,255
Cash, Foreign Currency, and Other Monetary Assets	387,270	92,330
Gold and Silver Reserves	11,062	11,062
Investments and Related Interest	10.576	10,074
Tax, Other, and Related Interest Receivables, Net	30,878	27,559
Other Assets	25,374	12,903
Total Assets	**11,117,038**	**9,528,807**
Federal Debt and Interest Payable	10,075,108	9,029,038
Other Intra-governmental Liabilities	681,621	343,466
Other Liabilities	50,598	35,204
Total Liabilities	**10,807,327**	**9,407,708**
Unexpended Appropriations	271,968	72,317
Cumulative Results of Operations	37,743	48,782
Total Net Position	**309,711**	**121,099**
Total Liabilities and Net Position	**$ 11,117,038**	**$ 9,528,807**

CONDENSED CONSOLIDATED STATEMENTS OF NET COST (in Millions):	**2008**	**2007**
Net Financial Program Cost	$ 12,287	$ 11,735
Net Economic Program (Revenue)/Cost	248	(456)
Net Security Program Cost	342	300
Net Management Program Cost	466	440
Total Net Cost of Treasury Operations	**13,343**	**12,019**
GSE Costs	13,800	—
Net Federal Costs (primarily interest on the Federal Debt)	$ 442,208	$ 429,302

CONDENSED STATEMENTS OF CUSTODIAL ACTIVITY (in Millions):	**2008**	**2007**
Individual and FICA Taxes	$ 2,294,326	$ 2,201,464
Corporate Income Taxes	354,063	395,320
Other Revenues	144,218	142,005
Total Revenue Received	**2,792,607**	**2,738,789**
Less Refunds	(426,074)	(292,684)
Net Revenue Received	**2,366,533**	**2,446,105**
Accrual Adjustment	3,132	5,588
Total Custodial Revenue	**2,369,665**	**2,451,693**
Amounts Provided to Fund the Federal Government	2,366,126	2,445,619
Other	407	486
Accrual Adjustment	3,132	5,588
Total Disposition of Custodial Revenue	**2,369,665**	**2,451,693**
Net Custodial Revenue Activity	**$ 0**	**$ 0**

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION (in Millions):	**2008**	**2007**
Beginning Balance	$ 48,782	$ 46,644
Budgetary Financing Sources	482,150	447,331
Other Financing Sources (Uses)	(23,838)	(3,872)
Total Financing Sources	458,312	443,459
Net Cost of Operations	(469,351)	(441,321)
Net Change	(11,039)	2,138
Cumulative Results of Operations	**37,743**	**48,782**
Beginning Balance	72,317	68,270
Appropriations Received	681,473	451,222
Appropriations Used	(481,735)	(447,057)
Other	(87)	(118)
Total Budgetary Financing Sources	199,651	4,047
Total Unexpended Appropriations	**271,968**	**72,317**
Net Position - Year End	**$ 309,711**	**$ 121,099**

CONDENSED COMBINED STATEMENTS OF BUDGETARY RESOURCES (in Millions):	**2008**	**2007**
Unobligated Balance, Brought Forward	$ 57,450	$ 57,540
Recoveries of Prior Year Unpaid Obligations	413	474
Budget Authority	722,859	474,974
Other Budget Authority	(8,558)	(10,008)
Total Budgetary Resources	**772,164**	**522,980**
Obligations Incurred	487,534	465,530
Unobligated Balance	273,235	46,455
Unobligated Balance Not Available	11,395	10,995
Total Status of Budgetary Resources	**772,164**	**522,980**
Total Unpaid Obligated Balances, Net	57,393	52,448
Obligations Incurred, Net	487,534	465,530
Gross Outlays	(487,608)	(460,302)
Recoveries of Prior Year Unpaid Obligations, Actual	(413)	(474)
Changes in Uncollected Customer Payments Federal	71	191
Total Unpaid Obligated Balance, Net, End of Year	**56,977**	**57,393**
Gross Outlays	487,608	460,302
Offsetting Collections & Distributed Offsetting Receipts	(24,740)	(24,232)
Net Outlays	**$ 462,868**	**$ 436,070**

AUDITOR'S REPORT ON THE TREASURY DEPARTMENT'S FINANCIAL STATEMENTS

The Department received an unqualified audit opinion on its fiscal year 2008 financial statements. The auditor reported a material weakness related to financial systems and reporting at the IRS and significant deficiencies related to financial management practices at the departmental level and controls over foreign currency transactions. The auditor also reported an instance of noncompliance with laws and regulations related to Section 6325 of the Internal Revenue Code and that the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996. In addition, a potential Anti-deficiency Act violation related to transactions and activities of the Financial Crimes Enforcement Network was reported.

Summary of Financial Statement Audit

Audit Opinion	Unqualified				
Restatement	No				
Material Weakness	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Financial Systems and Reporting at the IRS	1	0	0	0	1

Limitations on the Principal Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the Department of the Treasury, pursuant to the requirements of 31 U.S.C. 3515 (b). While the statements have been prepared from the books and records of the Department of the Treasury, in accordance with GAAP for federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The financial statements should be read with the realization that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

Major Highlights

The following provides the highlights of Treasury's financial position and results of operations for fiscal year 2008.

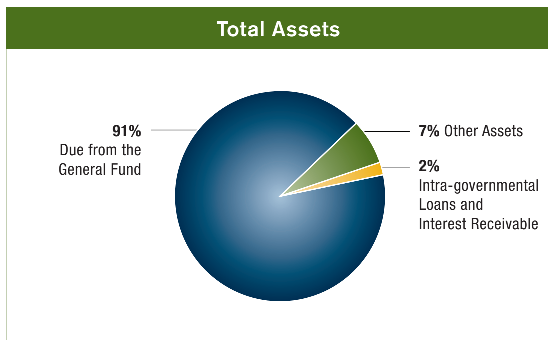
MAJOR HIGHLIGHTS

The following provides the major highlights of Treasury's financial position and results of operations for fiscal year 2008.

Assets. Total assets increased from $9.5 trillion at September 30, 2007, to $11.1 trillion at September 30, 2008. The primary reason for the increase is the rise in the federal debt, which causes a corresponding rise in the "Due from the General Fund of the U.S. Government" account ($10.1 trillion). This account represents future funds required from the General Fund of the U.S. Government to pay borrowings from the public and other federal agencies.

The majority of loans and interest receivable ($264.9 billion) included in "Intra-governmental" assets are the loans issued by the Bureau of the Public Debt to other federal agencies for their own use or to private sector borrowers, whose loans are guaranteed by the federal agencies.

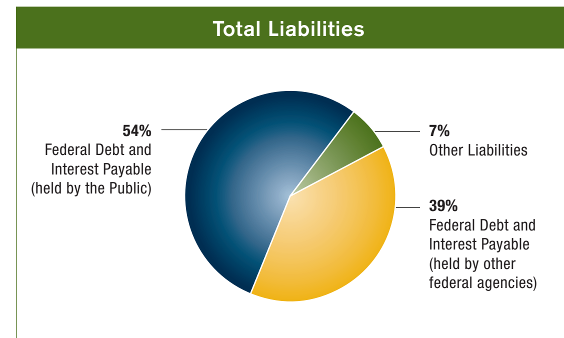
Total Assets



Liabilities. Intra-governmental liabilities totaled $4.9 trillion, and include $4.3 trillion of principal and interest payable to various federal agencies such as the Social Security Trust Fund.

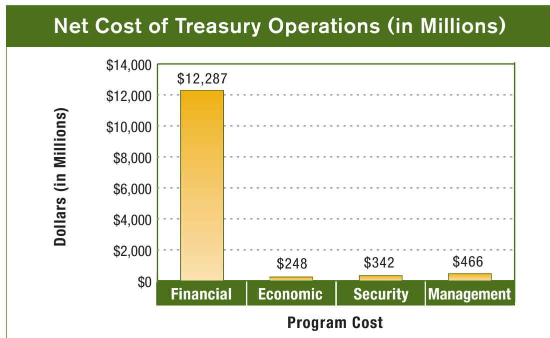
Liabilities also include federal debt held by the public, including interest, of $5.8 trillion; this debt was mainly issued as Treasury Notes. The increase in total liabilities in fiscal year 2008 over fiscal year 2007 ($1.4 trillion and 14.9%) is the result of increases in borrowings from various federal agencies ($257 billion), and federal debt held by the public, including interest ($759.4 billion). Debt held by the public increased primarily because of the need to finance budget deficits.

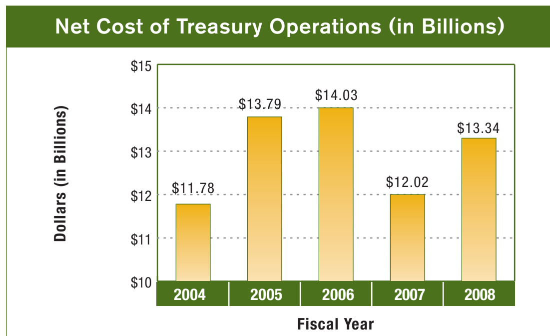
Total Liabilities



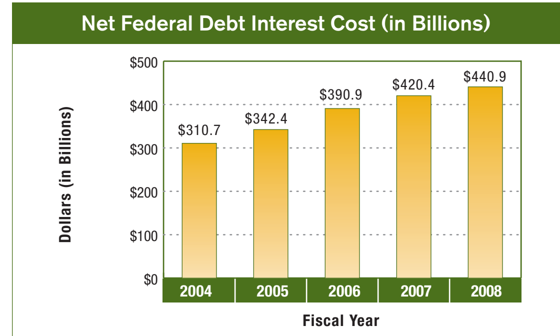
Net Cost of Treasury Operations. The Consolidated Statement of Net Cost presents the Department's gross and net cost for its four strategic missions: financial program, economic program, security program, and management program. The majority of the Net Cost of Treasury Operations is in the financial program. Treasury is the primary fiscal agent for the Federal Government in managing the nation's finances by collecting revenue, making federal payments, managing federal borrowing, performing central accounting functions, and producing coins and currency sufficient to meet demand.

Net cost (not from Treasury operations) includes $13.8 billion related to the GSE Keepwell agreement.

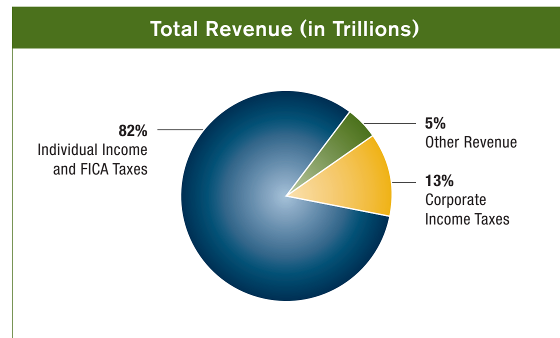




Net Federal Debt Interest Costs. Interest costs have increased over the past four years due to the increase in the federal debt.



Custodial Revenue. Total net revenue collected by Treasury on behalf of the Federal Government includes various taxes, primarily income taxes, user fees, fines and penalties, and other revenue. Over 94.8 percent of the revenues are from income and social security taxes.



IMPROPER PAYMENTS INFORMATION ACT AND RECOVERY AUDITING ACT

IMPROPER PAYMENTS INFORMATION ACT

Background

The Improper Payments Information Act of 2002 (IPIA) requires agencies to review their programs and activities annually to identify those susceptible to significant improper payments. According to Office of Management and Budget (OMB) Circular A-123, Appendix C, *Requirements for Effective Measurement and Remediation of Improper Payments* (A-123, Appendix C), "significant" means that an estimated error rate and a dollar amount exceed the threshold of 2.5 percent and $10 million of total program funding. A-123, Appendix C also requires the agency to implement a corrective action plan that includes improper payment reduction and recovery targets.

However, some federal programs are so complex that developing an annual error rate is not feasible. The government-wide Chief Financial Officers Council developed an alternative for such programs to assist them in meeting the IPIA requirements. Agencies may establish an annual estimate for a high-risk component of a complex program (*e.g.*, a specific program population) with OMB approval. Agencies must also perform trend analyses to update the program's baseline error rate in the interim years between detailed program studies. When development of a statistically valid error rate is possible, the reduction targets are revised and become the basis for future trend analyses.

Treasury's Risk Assessment Methodology and Results for Fiscal Year 2008

Each year, Treasury develops a comprehensive inventory of all funding sources and conducts a risk assessment for improper payments on all of its programs and activities. The risk assessment performed on all of Treasury's programs and activities resulted in low and medium risk susceptibility for improper payments except for the Internal Revenue Service's (IRS) Earned Income Tax Credit (EITC) program. The high-risk status of this program is well-documented and has been deemed a complex program for the purposes of the IPIA.

Earned Income Tax Credit

The EITC is a refundable tax credit that offsets income tax owed by low-income taxpayers and, if the credit exceeds the amount of taxes due, provides a lump-sum payment in the form of a refund to those who qualify. The fiscal year 2008 estimate is that a maximum of 28 percent ($13.1 billion) and a minimum of 23 percent ($11.1 billion) of the EITC total program payments are overclaims.

The IRS has a robust base enforcement program for the EITC which consists of examinations, math error notices, and document matching and has adopted a two-pronged approach to reduce improper payments:

- Seek opportunities to increase program efficiency within existing resources
- Test potential new approaches and processes and then request implementation funding if the tests prove successful

RECOVERY AUDITING ACT

Background

In accordance with the Recovery Auditing Act, OMB Circular A-123, Appendix C, requires agencies issuing $500 million or more in contracts to establish and maintain recovery auditing activities and report on the results of those recovery efforts annually. Recovery auditing activities include the use of (1) contract audits, in which an examination of contracts pursuant to the audit and records clause incorporated in the contract is performed; (2) contingency contracts for recovery services in which the contractor is paid a percentage of the recoveries; and (3) internal review and analysis in which payment controls are employed to ensure that contract payments are accurate.

For Recovery Act compliance, Treasury requires each bureau and office to review their post-payment controls and report on recovery auditing activities, contracts issued, improper payments made, and recoveries achieved. Bureaus and offices may use recovery auditing firms to perform many of the steps in their recovery program and identify candidates for recovery action.

Results for Fiscal Year 2008

During fiscal year 2008, $5.0 billion in contracts (defined as issued and obligated contracts, modifications, task orders, and delivery orders) were issued. Improper payments in the amount of $825,279 were identified from recovery auditing efforts, and $839,818 has been recovered, including prior year recoveries, with $1,834 outstanding as accounts receivable on September 30, 2008.

Note: Additional detail on Treasury's IPIA and Recovery Auditing Act Program can be found in *Appendix B*.

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MANAGEMENT ASSURANCES

The Secretary's Letter of Assurance

The Department of the Treasury's management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA). Treasury has evaluated its management controls, internal controls over financial reporting, and compliance with federal financial systems standards. As part of the evaluation process, we considered results of extensive testing and assessment across the Department and the results of independent audits.

Treasury provides reasonable assurance that the objectives of the Federal Managers' Financial Integrity Act over operations have been achieved, except for the material weaknesses noted below. In accordance with OMB Circular A-123, Appendix A, we provide qualified assurance that internal control over financial reporting is effective as of June 30, 2008. Treasury is not in substantial compliance with the Federal Financial Management Improvement Act due to the material weakness involving revenue accounting systems; this weakness is a significant reason for our qualified overall assurance level for A-123, Appendix A.

Treasury has four remaining material weaknesses as of September 30, 2008, as follows:

Operations:

Internal Revenue Service

- Systems modernization management and controls
- Systems security controls

Financial Management Service

- Systems, controls, and procedures to prepare the Government-wide financial statements

Financial Reporting:

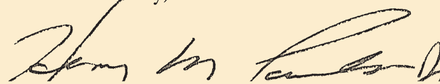
Internal Revenue Service

- Revenue accounting systems

The Department made significant progress during fiscal year 2008 by closing two of six material weaknesses. For the sixth straight fiscal year, we identified no new material weaknesses. We will continue to focus on achieving positive results by:

- Emphasizing internal control program responsibilities throughout Treasury
- Ensuring senior management attention to management controls
- Focusing on the need to develop and carry out responsible plans for resolving weaknesses

Sincerely,



Henry M. Paulson, Jr.
November 17, 2008

MATERIAL WEAKNESSES, AUDIT FOLLOW-UP, AND FINANCIAL SYSTEMS

SUMMARY OF MANAGEMENT ASSURANCE

Summary of Material Weaknesses						
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
IRS - Revenue Accounting Systems	1	0	0	0	0	1
IRS - Systems Modernization Management and Controls	1	0	0	0	0	1
IRS - Overclaims in the Earned Income Tax Credit Program	1	0	1	0	0	0
IRS - Systems Security Controls	1	0	0	0	0	1
FMS - Systems, Controls and Procedures to Prepare the Government-wide Financial Statements	1	0	0	0	0	1
DO - Systems Security	1	0	1	0	0	0
TOTAL MATERIAL WEAKNESSES	6	0	2	0	0	4

During fiscal year 2008, Treasury closed two material weaknesses: Treasury Departmental Offices Lack of Compliance with the FISMA, and IRS Overclaims in the Earned Income Tax Credit.

As of September 30, 2008, Treasury has four remaining material weaknesses under Section 2 of the FMFIA as shown in the tables below.

Effectiveness of Internal Control over Financial Reporting (FMFIA § 2)						
Statement of Assurance	Qualified Assurance					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
IRS - Revenue Accounting Systems	1	0	0	0	0	1
TOTAL MATERIAL WEAKNESSES	1	0	0	0	0	1

Effectiveness of Internal Control over Operations (FMFIA § 2)						
Statement of Assurance	Qualified Assurance					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
IRS - Systems Modernization Management and Controls	1	0	0	0	0	1
IRS - Overclaims in the Earned Income Tax Credit Program	1	0	1	0	0	0
IRS - Systems Security Controls	1	0	0	0	0	1
FMS - Systems, Controls, and Procedures to Prepare the Government-wide Financial Statements	1	0	0	0	0	1
DO - Systems Security	1	0	1	0	0	0
TOTAL MATERIAL WEAKNESSES	5	0	2	0	0	3

Conformance with Financial Management System Requirements (FMFIA § 4)						
Statement of Assurance	Systems conform to financial management system requirements					
Non-Conformances	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
TOTAL NON-CONFORMANCES	0	0	0	0	0	0

Compliance with Federal Financial Management Improvement Act (FFMIA)		
	Agency	Auditor
Overall Substantial Compliance	No	No
1. System Requirements	No	
2. Accounting Standards	No	
3. USSGL at Transaction Level	No	

Federal Managers' Financial Integrity Act (FMFIA)

The management control objectives under FMFIA are to reasonably ensure that:

- programs achieve their intended results
- resources are used consistent with overall mission
- programs and resources are free from waste, fraud, and mismanagement
- laws and regulations are followed
- controls are sufficient to minimize any improper or erroneous payments
- performance information is reliable
- system security is in substantial compliance with all relevant requirements
- continuity of operations planning in critical areas is sufficient to reduce risk to reasonable levels
- financial management systems are in compliance with federal financial systems standards

Deficiencies that seriously affect an agency's ability to meet these objectives are deemed "material weaknesses." Treasury can provide reasonable assurance that the objectives of FMFIA have been achieved, except for the remaining material weaknesses noted in the Secretary's Letter of Assurance. The last identified material weakness is targeted for closure in fiscal year 2012.

Each year material weaknesses, both the resolution of existing ones and the prevention of new ones, receive special attention. Over the past six years, Treasury has made great progress in reducing the number of material weaknesses. During fiscal year 2008, the Department closed two of six material weaknesses and continues to make resolution of these weaknesses a performance requirement for every executive, manager, and supervisor.

Office of Management and Budget (OMB) Circular A-123, Appendix A

The Department continues to strengthen and improve the execution of the Treasury mission through the application of sound internal controls over financial reporting. In response to OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A, Treasury developed and implemented an extensive testing and assessment methodology that identified and documented internal controls over financial reporting at the transaction level integrated with the Government Accountability Office's Standards for Internal Control. The testing and assessment were completed across all material Treasury bureaus and offices by June 30, 2008. Treasury provides qualified reasonable assurance that internal controls over financial reporting are effective as of June 30, 2008, due in large part to the revenue accounting system weaknesses at the IRS.

Federal Financial Management Improvement Act (FFMIA)

FFMIA mandates that agencies "... implement and maintain financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the United States Government Standard General Ledger at the transaction level." FFMIA also requires that remediation plans be developed for any entity that is unable to report substantial compliance with these requirements.

As of September 30, 2008, the Treasury Department's financial management systems were not in substantial compliance with FFMIA due to deficiencies with the IRS's financial management systems. The IRS has a remediation plan in place to correct the deficiencies. For each FFMIA recommendation, the remediation plan identifies specific remedies, target dates, responsible officials, and resource estimates required for completion. This plan is reviewed and updated quarterly. (Refer to Appendix D for detailed information.)

Audit Follow-Up

During fiscal year 2008, Treasury placed a renewed emphasis on improving both the general administration of management control issues throughout the Department and the timeliness of the resolution of all findings and recommendations identified by the Office of the Inspector General (OIG), the Treasury Inspector General for Tax Administration (TIGTA), the Government Accountability Office, and external auditors.

Treasury management at every level will maintain the momentum on accomplishing Planned Corrective Actions (PCAs) timely to resolve and implement sound solutions for all audit recommendations. Although the Department has made great progress, considerably more work lies ahead to integrate the effects of those actions more fully into management's decision-making processes. The Department needs to identify more precisely what it costs to accomplish Treasury's varied missions and develop ways to improve overall performance. This will entail building upon the progress already made in expanding the communication and coordination among the Treasury offices variously involved in strategic planning, budget formulation, budget execution, performance management, and financial management.

Financial Management Systems Framework

The Department's overall financial management systems framework consists of a Treasury-wide financial data warehouse, supported by a financial reporting tool and separate bureau financial systems. Bureaus submit their monthly financial data to the data warehouse within three business days of the month-end. The Department then produces monthly financial statements and reports for management analysis. This framework satisfies both the bureaus' diverse financial operational and reporting needs, as well as the Department's internal and external reporting requirements. The financial data warehouse is part of the overarching Treasury-wide Financial Analysis and Reporting System (FARS), which also includes applications for bureaus to report the status of their performance measures and the status of their planned audit corrective actions. Treasury has also implemented a budget application which is used by the Departmental Offices (DO) in the management of DO's budget expenditures. Additional FARS applications are planned to improve the Department's financial management and operations. This includes asset management and enhanced reporting functionality.

Treasury's FARS applications operate at a contractor operated hosting facility. In accordance with the guidance contained in the American Institute of Certified Public Accountants' Statement of Auditing Standards (SAS) No. 70, *Service Organizations*, the service provider's independent auditors examined the controls for the dedicated hosting service. In the opinion of the auditors, the description of the controls presents fairly, in all material respects, the relevant aspects of the provider's controls that had been placed in operation as of September 30, 2008. Also, the controls described are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily and customer organizations applied

the controls contemplated in the design of the provider's controls.

The Department continues to enhance its financial management systems structure. As of September 30, 2008, the number of financial management systems decreased to 60, down from 64 at the end of fiscal year 2007.

The Bureau of the Public Debt's Administrative Resource Center (ARC) has been designated by OMB as a Financial Management Line of Business Shared Service Provider (SSP). The ARC currently services 28 federal entities for core financial systems, including twelve Treasury bureaus and reporting entities. Treasury will continue to evaluate opportunities to consolidate financial management systems and better utilize existing resources. The Department will work with the remaining bureaus to develop plans to migrate to a SSP for core financial systems in accordance with the Financial Management Line of Business requirements.

The ARC also provides systems and service support to eleven Department bureaus in the processing of their travel needs as part of the Department's E-Gov Travel initiative. Of the three remaining bureaus, two are exempt from the Federal Travel Regulations and do not plan to migrate at this time. The IRS, which is not cross-serviced by the ARC, began a phased implementation to the E-Government travel system in May 2008.

The Department's FARS applications are also used to support other federal agencies. Treasury currently hosts another federal agency for consolidated financial processing and reporting. As a result of this arrangement, Treasury is able to share costs for the maintenance and operation of the FARS applications. In addition, the Department has demonstrated various FARS applications to other agencies. Several of the agencies have implemented FARS applications to run in their own systems environment, reducing their capital investment in systems software development.

The Department of the Treasury

PERFORMANCE & ACCOUNTABILITY REPORT

fiscal year 2008

THE UNITED STATES DEPARTMENT OF THE TREASURY

OUR VISION

Set the global standard in financial and economic leadership

OUR MISSION

Serve the American people and strengthen national security by managing the U.S. Government's finances effectively, promoting economic growth and stability, and ensuring the safety, soundness, and security of the U.S. and international financial systems

OUR VALUES

SERVICE – Work for the benefit of the American people

INTEGRITY – Aspire to the highest levels ethical standards of honesty, trustworthiness, and dependability

EXCELLENCE – Strive to be the best, continuously improve, innovate, and adapt

OBJECTIVITY – Encourage independent views

ACCOUNTABILITY – Responsible for our conduct and work

COMMUNITY – Dedicated to excellent customer service, collaboration, and teamwork while promoting diversity

FISCAL YEAR 2008

PERFORMANCE & ACCOUNTABILITY REPORT

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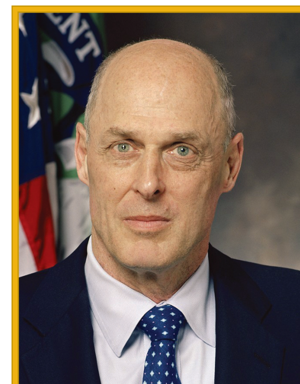
MESSAGE FROM THE SECRETARY



November 17, 2008

On behalf of the Department of the Treasury, I am pleased to submit the Fiscal Year 2008 Performance and Accountability Report. This annual report provides insight into the Department's broad leadership role for the economic and financial activities of the U.S. Government. The current economic turmoil calls for extraordinary measures, and the Treasury Department has actively pursued initiatives aimed at stabilizing the financial system and strengthening financial institutions that play a vital role in supporting U.S. economic activity.

Maintaining and improving the performance of the Department is crucial. In fiscal year 2008, the Department of the Treasury met or exceeded 70 percent of its performance targets, slightly lower than fiscal year 2007. Though the result is lower than the prior year, Treasury improved the quality of its measures through innovative approaches to measure difficult areas, such as Terrorism and Financial Intelligence, and economic and financial technical assistance provided to other countries.

This year brought two additional management challenges for the Department: *Management of Treasury's New Authorities Related to Distressed Financial Markets* and *Regulation of National Banks and Thrifts*. Treasury recognizes the importance of sound stewardship in managing the authorities related to distressed financial markets. We are executing the authorities we have been granted with one primary goal – to restore liquidity and stability to the financial system of the United States. More broadly, we are reviewing the regulation of national banks and thrifts to identify gaps in regulatory authority and the regulatory framework that contributed to the current financial turmoil, and putting forward policies to modernize our financial regulatory architecture to match the evolution of the financial marketplace.

The Department of the Treasury has again received an unqualified opinion on its financial statements. The Department has validated the accuracy, completeness, and reliability of the financial data in this report. Performance data has been validated, and is likewise complete and reliable. The Department has continued to make progress in reducing management control weaknesses and in efforts to satisfy federal financial systems and control objectives.

Sincerely,

Henry M. Paulson, Jr.
Secretary of the Treasury

The Department of the Treasury
ANNUAL FINANCIAL REPORT

PART III

TAB A - Department of the Treasury Materials

MESSAGE FROM THE ASSISTANT SECRETARY FOR MANAGEMENT AND CHIEF FINANCIAL OFFICER

November 17, 2008

Secretary Paulson's message describes the Department of the Treasury's unprecedented role and expanded responsibilities in helping to stabilize the nation's economy. During the first critical weeks following enactment of the Housing and Economic Recovery Act and the Emergency Economic Stabilization Act, Treasury professionals in the areas of procurement, financial management, information technology, human capital, and operations acted swiftly to ensure that these functions were mobilized to support rapid implementation. We anticipate a continuing critical role for these teams in fiscal year 2009 in support of the Troubled Asset Relief Program and the newly established Office of Financial Stability.

During the course of the year, Treasury took a number of steps to strengthen corporate management councils and forums, including bureau head meetings and active Department-wide functional councils headed by the Chief Financial Officer, the Chief Information Officer, the Chief Human Capital Officer, the Senior Procurement Executive, and the Director of Emergency Programs. To strengthen the Department's privacy, governance, disclosure, and record-keeping programs, a new Office of Privacy and Treasury Records was established by combining key functions and elevating the integrated effort to report directly to the Assistant Secretary for Management. The Department also re-energized the E-Board Information Technology Investment Oversight forum to provide increased executive-level strategic direction and scrutiny of major projects, and strengthened corporate management of shared services by initiating an ongoing Working Capital Fund Review Program with participation by all bureaus.

The Department of the Treasury once again received an unqualified audit opinion on its financial statements. We are working diligently to resolve financial systems material weaknesses which are preventing the Department from achieving full compliance with federal financial systems requirements and, along with weaknesses in non-financial areas, result in providing only qualified assurance that the Department is meeting federal financial management and internal control objectives. The Department closed two long-standing material weaknesses in fiscal year 2008, and no new weaknesses were identified, leaving four open material weaknesses as of September 30, 2008. These remaining weaknesses involve complex solutions that will require several years of sustained, hard work to resolve. The last of the Department's material weaknesses is scheduled to be closed in fiscal year 2012. The Department will also need to devote special attention to the Management Challenges outlined by the Department's Inspectors General. These challenges do not necessarily indicate deficiencies in performance; however, they represent inherent risks that must be monitored continuously. This is especially true of the new challenges the Department faces in working to stabilize and improve the distressed financial markets.

In the coming months, as our nation awaits the beginning of a new Administration, the dedicated men and women of the Department of the Treasury will continue to carry out the vital mission of the Treasury Department on behalf of the American people, while making all necessary preparations to support a smooth and effective transition.

Sincerely,

Peter B. McCarthy
Assistant Secretary for Management
and Chief Financial Officer

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

November 17, 2008

INFORMATION MEMORANDUM FOR SECRETARY PAULSON

FROM: for Eric M. Thorson
Inspector General

SUBJECT: Audit of the Department of the Treasury's Financial Statements for Fiscal Years 2008 and 2007

INTRODUCTION

I am pleased to transmit KPMG LLP's report on the Department of the Treasury's (the Department) financial statements as of and for the fiscal years (FY) ending September 30, 2008 and 2007.

The Department of the Treasury Office of Inspector General is responsible for ensuring that the financial statement audit of the Department of the Treasury is conducted in accordance with the Chief Financial Officers' Act of 1990, as amended by the Government Management Reform Act of 1994.

RESULTS OF INDEPENDENT AUDIT

Under a contract monitored by my office, KPMG LLP, an independent certified public accounting firm, performed an audit of the FY 2008 and 2007 financial statements. The contract required that the audit be performed in accordance with generally accepted government auditing standards issued by the Comptroller General of the United States; Office of Management and Budget Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*; and the *GAO/PCIE Financial Audit Manual*.

In its audit of the Department of the Treasury, KPMG LLP

- found that the financial statements were fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles;
- reported that the three material weaknesses related to financial systems and reporting identified by the auditor of the Internal Revenue Service (IRS) are collectively considered a material weakness for the Department as a whole;
- reported that control deficiencies related to (1) financial management practices at the departmental level and (2) controls over foreign currency transactions represent significant deficiencies for the Department as a whole;
- reported an instance of noncompliance with laws and regulations related to the Internal Revenue Code Section 6325;
- reported that the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA); and
- reported an instance of a potential Anti-deficiency Act violation related to transactions and activities of the Financial Crimes Enforcement Network

IRS's pervasive internal control weaknesses have existed since audits of its financial statements were initiated in FY 1992. The Government Accountability Office (GAO), the auditor of IRS's financial statements for the fiscal years ending September 30, 2008 and 2007, reported that the bureau continued to make significant strides in addressing its financial management challenges and material weaknesses in its internal controls. In particular, IRS made progress to address control deficiencies over tax revenue and refunds such that GAO no longer considers the remaining control deficiencies in this area a material weakness. IRS also improved internal controls over safeguarding hard-copy taxpayer receipts and data that enabled GAO to conclude that the remaining issues in this area no longer constitute a significant deficiency. However, IRS faces serious challenges from its use of obsolete financial management systems that do not conform to the requirements of FFMIA. Until IRS resolves the issues affecting the automated systems it relies on to process tax related transactions, it will be challenged to sustain the level of effort needed to produce reliable financial statements in a timely manner. Continued IRS and Department senior leadership involvement is essential to effectively address IRS's remaining financial management challenges.

EVALUATION OF AUDITORS' PERFORMANCE

To ensure the quality of the audit work performed, we reviewed KPMG LLP's approach and planning of the audit, evaluated the qualifications and independence of the auditors, monitored the progress of the audit at key points, reviewed and accepted KPMG LLP's audit report, and performed other procedures that we deemed necessary. We also provide oversight of the audits of financial statements and certain accounts and activities conducted at 12 component entities of the Department. Our review, as differentiated from an audit in accordance with generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on the financial statements or conclusions about the effectiveness of internal control or on whether the Department's financial management systems substantially complied with the Federal Financial Management Improvement Act of 1996 or conclusions on compliance with laws and regulations. KPMG LLP is responsible for the attached auditor's report dated November 17, 2008, and the conclusions expressed in that report. However, our review disclosed no instances where KPMG LLP did not comply, in all material respects, with generally accepted government auditing standards.

I appreciate the courtesies and cooperation extended to KPMG LLP and my staff during the audit. Should you or your staff have questions, you may contact me at (202) 622-1090 or Marla A. Freedman, Assistant Inspector General for Audit, at (202) 927-5400.

Attachment

cc: Peter B. McCarthy
Assistant Secretary for Management
and Chief Financial Officer

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Inspector General
U.S. Department of the Treasury:

We have audited the accompanying consolidated balance sheets of the U.S. Department of the Treasury (Department) as of September 30, 2008 and 2007, and the related consolidated statements of net cost, and changes in net position, combined statements of budgetary resources, and the statements of custodial activity (hereinafter referred to as "consolidated financial statements") for the years then ended. The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. These consolidated financial statements are incorporated in the accompanying *U.S. Department of the Treasury Fiscal Year 2008 Performance and Accountability Report* (PAR).

We did not audit the amounts included in the consolidated financial statements related to the Internal Revenue Service (IRS), a component entity of the Department. The financial statements of the IRS were audited by another auditor whose report thereon has been provided to us. Our opinion, insofar as it relates to the amounts included for the IRS, is based solely on the report of the other auditor.

In connection with our fiscal year 2008 audit, we, and the other auditor, also considered the Department's internal control over financial reporting and tested the Department's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these consolidated financial statements. Our conclusions on internal control over financial reporting and compliance and other matters, insofar as it relates to the IRS, are based solely on the report of the other auditor.

Summary

As stated in our opinion on the consolidated financial statements, based on our audits and the report of the other auditor, we concluded that the Department's consolidated financial statements as of and for the years ended September 30, 2008 and 2007, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 24, 25, and 26, the Department is a participant in significant legislation and transactions whose purpose is to assist in stabilizing the financial markets.

Our, and the other auditor's consideration of internal control over financial reporting resulted in the following conditions being identified as significant deficiencies:

- Financial Systems and Reporting at the IRS (Repeat Condition)
- Financial Management Practices at the Departmental Level (Repeat Condition)
- Controls Over Foreign Currency Transactions

We consider the significant deficiency related to Financial Systems and Reporting at the IRS noted above, to be a material weakness.

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

The results of our tests, and the tests performed by the other auditor, of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed an instance of noncompliance with *Internal Revenue Code* (IRC) Section 6325, that is required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. In addition, the Department's financial management systems did not substantially comply with the *Federal Financial Management Improvement Act of 1996* (FFMIA) requirements related to compliance with Federal financial management system requirements (FFMSR), applicable Federal accounting standards, and the U.S. Government Standard General Ledger (SGL) at the transaction level.

We also reported a matter related to compliance with the *Anti-deficiency Act* at the Financial Crimes Enforcement Network (FinCEN). This potential violation is currently under review by the Government Accountability Office (GAO).

The following sections discuss our opinion on the Department's consolidated financial statements; our, and the other auditor's, consideration of the Department's internal controls over financial reporting; our, and the other auditor's, tests of the Department's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of the Department of the Treasury as of September 30, 2008 and 2007, and the related consolidated statements of net cost, changes in net position, the combined statements of budgetary resources, and the statements of custodial activity, for the years then ended.

We did not audit the amounts included in the consolidated financial statements related to the IRS, a component entity of the Department, which reflect total assets of $35.6 billion and $31.3 billion, net costs of operations of $12.2 billion and $11.7 billion, and custodial revenues of $2.8 trillion and $2.7 trillion, as of and for the years ended September 30, 2008 and 2007, respectively. The financial statements of the IRS, as of and for the years ended September 30, 2008 and 2007, were audited by another auditor whose report dated November 5, 2008, has been provided to us, and our opinion, insofar as it relates to the amounts included for the IRS, is based solely on the report of the other auditor.

In our opinion, based on our audits, and the report of the other auditor, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Department of the Treasury as of September 30, 2008 and 2007, and its net costs, changes in net position, budgetary resources, and custodial activity for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 24, 25, and 26, the Department is a participant in significant legislation and transactions whose purpose is to assist in stabilizing the financial markets.

The information in the PAR in Part I – *Management's Discussion and Analysis*, and the Required Supplemental Information section of Part III – *Annual Financial Report*, is not a required part of the consolidated financial statements, but is supplementary information required by U.S. generally accepted accounting principles. We, and the other auditor, have applied certain limited procedures, which consisted

principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audits, and the audits of the other auditor, were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The information in the Message from the Secretary, in the PAR in Part II – *Annual Performance Report*; and in Part IV – *Other Accompanying Information*, are presented for purposes of additional analysis and are not required as part of the consolidated financial statements. This information has not been subjected to auditing procedures and, accordingly, we express no opinion on it.

Internal Control Over Financial Reporting

Our, and the other auditor's, consideration of the internal control over financial reporting is described in the Responsibilities section of this report. Our consideration of internal control over financial reporting was for a limited purpose and would not necessarily disclose all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses. This report also includes our consideration of the results of the other auditor's testing of internal control over financial reporting that is reported on separately by the other auditor. The other auditor's consideration of internal control over financial reporting was for the purpose of providing an opinion on the effectiveness of IRS's internal controls. This report, insofar as it relates to the results of the other auditor, is based solely on the report of the other auditor.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Department's ability to initiate, authorize, record, process, or report financial data reliably in accordance with U.S. generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Department's consolidated financial statements that is more than inconsequential will not be prevented or detected by the Department's internal control. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Department's internal control.

In our fiscal year 2008 audit, we, and the other auditor, consider the deficiencies, summarized below, to be significant deficiencies in internal control over financial reporting. The significant deficiency related to Financial Systems and Reporting at the IRS noted below is considered to be a material weakness. Because of the IRS material weakness in internal controls discussed below, the other auditor's opinion on internal control stated that the IRS did not maintain effective internal control over financial reporting (including safeguarding of assets), or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws material in relation to the financial statements would be prevented or detected on a timely basis.

MATERIAL WEAKNESS

Financial Systems and Reporting at the IRS (Repeat Condition)

IRS continued to make progress in addressing weaknesses in internal control identified in previous years. However, significant deficiencies related to financial reporting, unpaid tax assessments, and information security controls continued to exist in fiscal year 2008.

These weaknesses adversely affect IRS's ability to fulfill its responsibilities as the nation's tax collector because it is unable to routinely obtain comprehensive, timely, accurate, and useful, information for day-to-day decision making. As a result, IRS personnel will continue to be challenged to sustain the level of effort needed to produce reliable financial statements timely until the IRS successfully addresses underlying systems and internal control weaknesses.

The material weaknesses in internal control over financial reporting identified by the auditors of IRS's financial statements, all of which are repeat conditions, and collectively considered a material weakness for the Department as a whole, are summarized as follows:

- Weaknesses in controls over the financial reporting process, resulting in IRS not (1) being able to prepare its balance sheet without extensive compensating procedures, and (2) having current and reliable ongoing cost information to support management decision making and to prepare cost-based performance measures;

- Weaknesses in controls over unpaid tax assessments, resulting in IRS's inability to properly manage unpaid tax assessments and leading to increased taxpayer burden; and

- Weaknesses in information security controls, resulting in increased risk of unauthorized individuals accessing, altering, or abusing proprietary IRS programs and electronic data and taxpayer information.

The material weaknesses in internal control noted above may adversely affect decisions by IRS's management that is based, in whole or in part, on information that is inaccurate because of these deficiencies.

Additional details related to the material weaknesses identified above have been provided to IRS management by the auditors of the IRS's financial statements in their report dated November 5, 2008.

Recommendations

Recommendations to address the material weaknesses discussed above have been provided to IRS management by the auditors of the IRS's financial statements. We recommend that the Assistant Secretary for Management and Chief Financial Officer (ASM/CFO) provide effective oversight to ensure that corrective actions are taken by the IRS to fully address this material weakness.

SIGNIFICANT DEFICIENCIES

Financial Management Practices at the Departmental Level (Repeat Condition)

Due to expanded accounting and reporting requirements and responsibilities of the Department, improvements continue to be needed in current financial management and reporting practices.

The Office of Accounting and Internal Control (AIC) within the Office of the Deputy Chief Financial Officer (ODCFO), is responsible for establishing and maintaining financial policies that guide consolidated financial reporting throughout the Department, and implementing internal controls to ensure the overall integrity of financial data reported at the consolidated level. AIC prepares consolidated financial statements including footnote and supplementary data, from trial balances and other financial data submitted by the components. AIC uses this information to compile the Department's consolidated financial statements. AIC is dependent on the Treasury components for complete, accurate, and timely submission of monthly financial data. Certain quality control procedures are conducted by AIC to ensure that component financial and other data is accurate and complete for inclusion in the consolidated financial statements. However, several control deficiencies were noted, as described below, that indicated a weak control environment, resulting in financial management and reporting weaknesses. These deficiencies in internal control over financial reporting are collectively considered a significant deficiency for the Department as a whole.

- We continue to note that AIC, in addition to other Departmental Offices such as the Office of Financial Management (OFM), and the Office of Performance Budgeting and Strategic Planning (OPBSP), have financial management infrastructures that are inadequately staffed for the financial reporting responsibilities of such a large and complex Executive Branch agency. Several key personnel having significant institutional knowledge of the Department's accounting and reporting processes within these offices are at or near retirement eligibility status. In the event of retirement or sudden prolonged absence of one or more of the key accounting individuals, Treasury would face a significant loss of operational and institutional knowledge absent a comprehensive, formalized succession plan, resulting in significant financial management deficiencies. In fiscal year 2008, we noted that AIC successfully replaced one key official that retired in the current year, and supplemented its existing staff with two additional staff members on detail from other Treasury components. Although this temporarily helped with AIC's short-term needs, AIC, OFM, and OPBSP's long-term human capital need of personnel who have the requisite financial accounting background, knowledge, and expertise, to assist in the financial management and reporting of such a large and complex executive branch agency remains to be addressed.

- AIC's supervisory and monitoring control procedures were not consistently performed and documented over certain financial data and other information transmitted by Treasury components. During our review of interim and final consolidated financial statements, we noted errors and discrepancies that were only corrected after they were identified during audit test work. In other instances, we noted inadequate and/or untimely follow-up of accounting and/or reporting issues.

- AIC has not yet formalized written policies and procedures for the required accounting and reporting of various non-routine, complex, and unique transactions, such as the reporting of the U.S. Mint's Seigniorage amount, accrued interest and discount on debt, transfers to the General Fund and Other, in the Department's consolidated financial statements.

- AIC procedures for monitoring compliance with existing, as well as new laws and regulations that apply to the Department need improvement. Specifically, we noted that there is no formal communication between Treasury's Office of General Counsel (OGC) and AIC on matters related to new legislation, the assessment of compliance requirements, if any, and subsequent actions to be taken by the Department. Currently, interpretation of new laws and regulations, and resulting compliance needs, are left up to the discretion and interpretation of Department personnel. Without a formal communication process, there is significant risk of noncompliance with laws and regulations by the Department and its components.

- Our reviews of Department-wide testing and reporting on internal control over financial reporting, in accordance with OMB Circular No. A-123, *Management's Responsibility for Internal Control* (A-123), continue to identify similar implementation issues as in prior years. Although the Department established an effective implementation plan (Plan) to assess, document, test, and report on internal control over financial reporting, certain Treasury components did not fully execute the Plan. Specifically, some components did not have, or provide verifiable and documented results to support their conclusion as to whether internal control over financial reporting was properly designed and operating effectively for certain areas in accordance with the Department's guidelines. In addition, the AIC, which is responsible for the Department-wide monitoring of A-123 compliance, did not effectively review the work performed by components to assess whether the methodology and implementation requirements had been followed.

- As a result of the *Housing and Economic Recovery Act* legislation of 2008, the Department was involved in various financial transactions unique to the Department. These transactions were processed in a shortened time-frame causing various control deficiencies related to documentation of policies and procedures and financial reporting. The Department overcame significant time and personnel resource constraints to appropriately execute, manage, and report the results of these unprecedented events and transactions all of which occurred during the last month of the fiscal year. One transaction type involved the purchase of GSE Mortgage Backed Securities (MBS) in the amount of $3.3 billion. The Department concluded that the purchase of GSE MBS should be accounted under the Federal Credit Reform Act of 1990, as amended (FCRA). FCRA has significant documentation requirements. Since the MBS program was implemented in a shortened time-frame, the Department did not properly document policies and procedures, and controls relating to the MBS accounting and reporting. The primary cause of this lack of documentation was that Treasury did not have the resources, including personnel to prepare the required documentation supporting the accounting, re-estimate valuation, and financial reporting of the MBS purchases under FCRA.

The *Federal Managers' Financial Integrity Act of 1982* (FMFIA) requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government (Standards).* The GAO defines "internal control" as an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The GAO *Standards* identify the control environment as one of the five key elements of control, which emphasizes the importance of control conscientiousness in management's operating philosophy and

commitment to internal control. These standards cover controls such as human capital practices, supervisory reviews, and segregation of duties, policies, procedures, and monitoring.

A-123 requires agencies to (1) develop and implement management controls; (2) assess the adequacy of management controls; (3) identify needed improvements; (4) take corresponding corrective actions; and (5) report annually on management controls in support of FMFIA. The issues we identified occurred mainly because certain key AIC and OFM financial personnel have excessive workloads, and there is insufficient time for these key financial personnel to devote to supervisory reviews and other financial management activities. This resulted in increased reliance being placed on the annual audit process to identify errors and omissions in the consolidated financial statements, as well as the Department's implementation of A-123.

Recommendations

We recommend that the ASM/CFO, Deputy CFO, and Deputy Assistant Secretary for Human Resources and Chief Human Capital Officer, with input from the Directors of AIC, OFM and OPBSP, as appropriate:

1. Complete a human capital needs assessment, with particular focus on the management skills needed to perform the daily operations of these offices. Once the human capital needs are assessed, hire staff, or consider transferring suitable staff from other offices within Treasury to meet these immediate needs.

2. Establish new policies or improve existing policies and procedures to ensure that:

   i. Quality control reviews are performed on the consolidated financial statements by responsible officials to ensure that all errors and inconsistencies are corrected in a timely manner; and

   ii. Adequate reviews are conducted by senior AIC officials on all documentation prepared to support consolidated financial statement amounts to ensure that the documents and information provided are accurate and complete, and such review is documented.

3. Ensure that documentation exists to support all new and/or unique accounting and reporting requirements as well as non-routine or complex accounting and reporting matters. For example, any new financial statement footnote disclosures that are developed should include a policy memo, financial statement footnote disclosure format as well as evidence of review by responsible officials within AIC of both the policy and the format to be followed.

4. Ensure that communication is initiated on a periodic basis (at least quarterly) with OGC, to obtain information and documentation on any new laws and regulations that apply at the Department/component level, including documentation of OGC's assessment of compliance requirements especially those having financial impact.

5. Monitor the A-123 work being conducted by components to ensure that the Department's A-123 guidance is fully implemented, and if not, document the rationale or mitgating factors that were considered for not following the Department's requirements.

6. Document policy and procedures related to FCRA transactions, periodically examine performance of the credit programs to re-estimate cash flow projections and assumptions, and have affected personnel continue to consult with other Federal agencies that have substantial credit reform accounting experience.

Controls Over Foreign Currency Transactions

Improvements are needed related to internal control over foreign currency investment transactions at the Exchange Stabilization Fund (ESF). ESF's foreign currency operations are managed on ESF's behalf by a designated fiscal agent. The fiscal agent is responsible for the monthly accounting and reporting to the ESF of foreign currency activities. The fiscal agent also provides data that supports various ESF financial statement disclosures such as for fair values. The ESF relies entirely on the financial information reported by the fiscal agent and incorporates the financial data reported monthly into its general ledger and financial statements. Although ESF's financial data are subject to detailed review and validation by the fiscal agent, ESF does not have sufficient internal independent checks and balances in place to ensure the accuracy and completeness of the transactions and balances reported to them by the fiscal agent. Comprehensive internal processes, procedures, and controls over foreign currency transactions are essential to ensure that these transactions and balances are complete and accurate, and appropriately reported.

Additional details related to the significant deficiency identified above will be provided to ESF management by the auditors of the ESF's financial statements.

Recommendations

Recommendations to address the significant deficiency discussed above will be provided to ESF management by the auditors of the ESF's financial statements. We recommend that the ASM/CFO provide effective oversight to ensure that corrective actions are taken by the ESF to fully address this significant deficiency.

Compliance and Other Matter

The results of certain of our tests, and the tests performed by the other auditor, of compliance as described in the Responsibilities section of this report, exclusive of those referred to in FFMIA, disclosed the following instance of noncompliance or other matters that is required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04.

- ***Noncompliance with IRC Section 6325*** - The IRC grants IRS the power to file a lien against the property of any taxpayer who neglects or refuses to pay all assessed Federal taxes. Under IRC Section 6325, the IRS is required to release a Federal tax lien within 30 days after the date the tax liability is satisfied, or has become legally unenforceable, or the Secretary of the Treasury has accepted a bond for the assessed tax. Instances were noted during the fiscal year 2008 audit where the IRS did not timely release the applicable Federal tax lien within 30 days of the tax liability being either paid off or abated as required by the IRC (Repeat Condition).

The results of our other tests, and the tests performed by the other auditor, of compliance as described in the Responsibilities section of this report, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04.

The results of our tests of FFMIA, and the tests performed by the other auditor, disclosed instances where the Department's financial management systems did not substantially comply with FFMIA Section 803(a) requirements (Repeat Condition) related to compliance with (1) federal financial management system requirements (FFMSR), (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger (SGL) at the transaction level, as described below.

Instances of noncompliance with FFMSR are summarized below:

- IRS's financial management systems do not provide timely and reliable information for financial reporting and preparation of financial statements. IRS had to rely on extensive compensating procedures to generate reliable financial statements.

- Deficiencies were identified in information security controls at the IRS, resulting in increased risk of unauthorized individuals accessing, altering, or abusing proprietary IRS programs and electronic data and taxpayer information.

Instances of noncompliance with Federal accounting standards are summarized below:

- Material weaknesses at the IRS related to controls over financial reporting and unpaid tax assessments.

- IRS's financial management system cannot produce reliable, current information on the costs of its activities available to support decision making on a routine basis, consistent with the requirements of Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Standards*.

An instance of noncompliance with the SGL at the transaction level is summarized below:

- IRS's core general ledger system for tax-related activities does not comply with the SGL at the transaction level and also does not post transactions in conformance with SGL posting models.

The Secretary of the Treasury also stated in his Letter of Assurance, included in Part I – *Management's Discussion and Analysis*, of the accompanying PAR that the Department cannot provide assurance that its financial management systems are in substantial compliance with FFMIA. The Department's remedial actions and related time frames are presented in Appendix D of the PAR.

FFMIA requires that if the head of an agency determines that its financial management systems do not substantially comply with FFMIA, a remediation plan must be developed, in consultation with OMB that describes the resources, remedies, and intermediate target dates for achieving substantial compliance. FFMIA also requires OMB concurrence with any plan not expected to bring the agency's system into substantial compliance within three years after a determination of noncompliance is made.

IRS has established a remediation plan to address the conditions affecting its systems' inability to comply substantially with the requirements of FFMIA. This plan outlines the actions to be taken to resolve these issues, but these actions are long term in nature and are tied to IRS's system modernization efforts.

Recommendation

We recommend that the ASM/CFO provide effective oversight to ensure that (1) IRS implements appropriate controls so that Federal tax liens are released in accordance with Section 6325 of the IRC; and (2) IRS implements its plan of action to solve financial management problems so as to enable resolving the identified instances of financial management systems noncompliance with the requirements of FFMIA. Detailed recommendations to address the noncompliance findings discussed above have been provided to IRS management by the auditors of the IRS's financial statements.

Other Matter

The Department's management informed us of an instance of a potential *Anti-deficiency Act* violation related to transactions and activities of FinCEN. Specifically, budgetary control weaknesses existing within FinCEN may have allowed a potential violation of the *Anti-deficiency Act*. This matter is currently under review by the GAO.

Management's Response to Internal Control and Compliance Findings

The Department's management has indicated in a separate letter immediately following this report that it concurs with the findings presented in this section of our report. Further, it has responded that it will take corrective action, as necessary, to ensure the matters presented are addressed by the respective component management within the Department. We did not audit the Department's response and, accordingly, we express no opinion on it.

* * * * *

We noted certain additional matters involving internal control over financial reporting and its operation that we will report to the Department's management in a separate letter.

Responsibilities

Management's Responsibilities. Management is responsible for the consolidated financial statements; establishing and maintaining effective internal control; and complying with laws, regulations, contracts, and grant agreements applicable to the Department.

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2008 and 2007 consolidated financial statements of the Department based on our audits and the report of the other auditor. We, and the other auditor, conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 07-04. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit

procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall consolidated financial statement presentation.

We believe that our audits, and the report of the other auditor, related to the amounts included for the IRS, provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2008 audit, we considered the Department's internal control over financial reporting, exclusive of the internal control over financial reporting related to the IRS, by obtaining an understanding of the design effectiveness of the Department's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. Internal control over financial reporting related to the IRS was considered by the other auditor whose report thereon dated November 5, 2008 has been provided to us. We, and the other auditor, did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to express an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting. The objective of the other auditor's audit was to express an opinion on the effectiveness of the IRS's internal control over financial reporting. Accordingly, the other auditor provided an opinion on IRS's internal control over financial reporting.

As part of obtaining reasonable assurance about whether the Department's fiscal year 2008 consolidated financial statements are free of material misstatement, we, and the other auditor, performed tests of the Department's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, including the provisions referred to in Section 803(a) of FFMIA. We, and the other auditor, limited our tests of compliance to the provisions described in the preceding sentence, and we, and the other auditor, did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the Department. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the Department's management, the Department's Office of Inspector General, OMB, the GAO, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 17, 2008

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

November 17, 2008

KPMG LLP
2001 M Street, N.W.
Washington, D.C. 20036

Ladies and Gentlemen:

On behalf of Secretary Paulson, I am responding to your draft audit report on the Department of the Treasury's fiscal year (FY) 2008 consolidated financial statements. All of our bureaus and program offices can be proud of the Department's success in issuing a timely and accurate Performance and Accountability Report for the seventh consecutive year of accelerated reporting. Further, they are to be congratulated for overcoming many obstacles to achieve another unqualified opinion on the Department's financial statements.

These successful results also are due in large part to the high level of professionalism, technical expertise, and partnership demonstrated by KPMG in conducting the audit. Treasury has appreciated your efforts during the audit process to provide timely, constructive advice on how to improve our financial reporting. Treasury is equally appreciative of the expertise and commitment level demonstrated by the other organizations involved in the audit process – the Office of Inspector General (OIG), the Government Accountability Office (GAO), and the firms that audited several of our bureaus.

The Department of the Treasury continued to make significant progress during FY 2008 to address financial and information management deficiencies. The Office of the Chief Information Officer made substantial improvements in Treasury's Information Security Program and achieved an audit outcome from the OIG of "significant progress in compliance" with the Federal Information Security Management Act (FISMA), for both Treasury unclassified and National Intelligence systems. As a result, the Department formally closed the longstanding FISMA compliance material weakness in September 2008. As reported by GAO, the Internal Revenue Service made significant progress in addressing its controls over the collection of tax revenues due to the federal government and over the issuance of tax refunds.

We acknowledge the Departmental level material weakness, the significant deficiencies, and the instances of noncompliance with laws and regulations described in your report. We agree with your recommendations. We will focus on necessary corrective actions to address each of these items.

We appreciate the continuing professional, cooperative relationship that exists with both KPMG and the Office of Inspector General.

Sincerely,

Peter B. McCarthy
Assistant Secretary for Management
and Chief Financial Officer

CONSOLIDATED BALANCE SHEETS

As of September 30, 2008 and 2007

(In Millions)

ASSETS	**2008**	**2007**
Intra-governmental Assets		
Fund Balance *(Note 2)*	$ 275,368	$ 74,767
Loans and Interest Receivable *(Note 3)*	264,854	236,932
Advances to the Black Lung Trust Fund *(Note 4 and Note 26)*	10,484	10,058
Due From the General Fund *(Note 4)*	10,100,763	9,052,624
Accounts Receivable and Related Interest *(Note 10)*	396	466
Other Intra-governmental Assets	13	32
Total Intra-governmental Assets	**$ 10,651,878**	**$ 9,374,879**
Cash, Foreign Currency, and Other Monetary Assets *(Note 5)*	387,270	92,330
Gold and Silver Reserves *(Note 6)*	11,062	11,062
Loans and Interest Receivable *(Note 3)*	172	175
Credit Program Receivables - Mortgage Backed Securities *(Note 3)*	3,385	0
Investments in Government Sponsored Enterprises *(Note 4, Note 7, and Note 13)*	7,032	0
Investments and Related Interest *(Note 7)*	10,576	10,074
Reserve Position in the International Monetary Fund *(Note 8)*	4,750	4,464
Investments in International Financial Institutions *(Note 9)*	5,546	5,521
Tax, Other, and Related Interest Receivables, Net *(Note 10)*	30,878	27,559
Inventory and Related Property, Net *(Note 11)*	698	638
Property, Plant, and Equipment, Net *(Note 12)*	2,077	2,086
Other Assets *(Note 3)*	1,714	19
Total Assets *(Note 13)*	**$ 11,117,038**	**$ 9,528,807**
Heritage Assets *(Note 12)*		
LIABILITIES		
Intra-governmental Liabilities		
Federal Debt and Interest Payable *(Note 4 and Note 14)*	$ 4,262,414	$ 3,974,788
Other Debt and Interest Payable *(Note 14)*	14,164	14,164
Due to the General Fund *(Note 4, Note 5, and Note 22)*	667,112	328,973
Other Intra-governmental Liabilities *(Note 17)*	345	329
Total Intra-governmental Liabilities	**$ 4,944,035**	**$ 4,318,254**
Federal Debt and Interest Payable *(Note 4 and Note 14)*	5,812,694	5,054,250
Certificates Issued to Federal Reserve Banks *(Note 5)*	2,200	2,200
Allocation of Special Drawing Rights *(Note 5)*	7,630	7,627
Gold Certificates Issued to Federal Reserve Banks *(Note 6)*	11,037	11,037
Refunds Payable *(Note 4 and Note 21)*	3,076	1,684
D.C. Pensions and Judiciary Retirement Actuarial Liability *(Note 15)*	8,803	8,992
Other Liabilities *(Note 17, Note 24 and Note 25)*	17,852	3,664
Total Liabilities	**$ 10,807,327**	**$ 9,407,708**
Commitments and Contingencies *(Note 16, Note 24 and Note 26)*		
NET POSITION		
Unexpended Appropriations: Earmarked Funds *(Note 22)*	$ 200	$ 200
Other Funds	271,768	72,117
Subtotal	271,968	72,317
Cumulative Results of Operations: Earmarked Funds *(Note 22)*	37,586	35,385
Other Funds	157	13,397
Subtotal	37,743	48,782
Total Net Position *(Note 18)*	**$ 309,711**	**$ 121,099**
Total Liabilities and Net Position	**$ 11,117,038**	**$ 9,528,807**

The accompanying notes are an integral part of these financial statements.

CONSOLIDATED STATEMENTS OF NET COST

For the Years Ended September 30, 2008 and 2007

(In Millions)

	2008	2007
Cost of Treasury Operations: *(Note 19)*		
Financial Program:		
Gross Cost	$ 14,569	$ 13,980
Less Earned Revenue	(2,282)	(2,245)
Net Program Cost	**$ 12,287**	**$ 11,735**
Economic Program:		
Gross Cost	$ 5,339	$ 5,660
Less Earned Revenue	(5,091)	(6,116)
Net Program Cost	**$ 248**	**$ (456)**
Security Program:		
Gross Cost	$ 346	$ 302
Less Earned Revenue	(4)	(2)
Net Program Cost	**$ 342**	**$ 300**
Management Program:		
Gross Cost	$ 631	$ $883
Less Earned Revenue	(165)	(443)
Net Program Cost	**$ 466**	**$ 440**
Total Program Gross Costs:	**$ 20,885**	**$ 20,825**
Total Program Gross Earned Revenues	**(7,542)**	**(8,806)**
Total Net Cost of Treasury Operations	**$ 13,343**	**$ 12,019**
GSE Costs (Entity) *(Note 24)*	$ 13,800	$ 0
Total Net Cost of Treasury Operations plus GSE	**$ 27,143**	**$ 12,019**
Federal Costs: *(Note 19)*		
Federal Debt Interest	$ 453,347	$ 432,153
Less Interest Revenue from Loans	(12,439)	(11,714)
Net Federal Debt Interest Costs	**$ 440,908**	**$ 420,439**
Other Federal Costs *(Note 19)*	$ 8,332	$ 8,863
Less GSE Revenue (non-Entity) *(Note 24)*	(7,032)	0
Net Federal Costs	**$ 442,208**	**$ 429,302**
Net Cost of Treasury Operations, GSE Cost, Federal Debt Interest, Other Federal Costs, and GSE Revenue	**$ 469,351**	**$ 441,321**

The accompanying notes are an integral part of these financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

For the Year Ended September 30, 2008

(In Millions)

	Combined Earmarked Funds	Combined All Other Funds	Eliminations	Consolidated Total
CUMULATIVE RESULTS OF OPERATIONS				
Beginning Balances	$ 35,385	$ 13,397	$ 0	$ 48,782
Budgetary Financing Sources:				
Appropriations Used	458	481,277	0	481,735
Non-exchange Revenue	134	144	(24)	254
Donations and Forfeitures of Cash/Equivalent	159	0	0	159
Transfers In/Out Without Reimbursement	0	(10)	0	(10)
Other	38	(26)	0	12
Other Financing Sources (non-exchange)				
Donation/Forfeiture of Property	112	0	0	112
Accrued Interest and Discount on Debt	0	(3,870)	0	(3,870)
Transfers In/Out Without Reimbursement	(52)	31	0	(21)
Imputed Financing Sources	60	1,147	(478)	729
Transfers to the General Fund and Other (Note 18)	(23)	(20,765)	0	(20,788)
Total Financing Sources	**886**	**457,928**	**(502)**	**458,312**
Net Cost of Operations	1,315	(471,168)	502	(469,351)
Net Change	2,201	(13,240)	0	(11,039)
Cumulative Results of Operations	**$ 37,586**	**$ 157**	**$ 0**	**$ 37,743**
UNEXPENDED APPROPRIATIONS				
Beginning Balances	$ 200	$ 72,117	$ 0	$ 72,317
Budgetary Financing Sources:				
Appropriations Received *(Note 18)*	458	681,015	0	681,473
Appropriations Transferred In/Out	0	24	0	24
Other Adjustments	0	(111)	0	(111)
Appropriations Used	(458)	(481,277)	0	(481,735)
Total Budgetary Financing Sources	**0**	**199,651**	**0**	**199,651**
Total Unexpended Appropriations	**$ 200**	**$ 271,768**	**$ 0**	**$ 271,968**
Net Position	**$ 37,786**	**$ 271,925**	**$ 0**	**$ 309,711**

The accompanying notes are an integral part of these financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

For the Year Ended September 30, 2007

(In Millions)

	Combined Earmarked Funds	Combined All Other Funds	Eliminations	Consolidated Total
CUMULATIVE RESULTS OF OPERATIONS				
Beginning Balances	$ 31,614	$ 15,030	$ 0	$ 46,644
Budgetary Financing Sources:				
Appropriations Used	390	446,667	0	447,057
Non-exchange Revenue	109	7	(43)	73
Donations and Forfeitures of Cash/Equivalent	210	0	0	210
Transfers In/Out without Reimbursement	0	(8)	0	(8)
Other	(1)	0	0	(1)
Other Financing Sources (non exchange)				
Donation/Forfeiture of Property	73	0	0	73
Accrued Interest and Discount on Debt	0	7,632	0	7,632
Transfers In/Out Without Reimbursement	(39)	15	0	(24)
Imputed Financing Sources	60	1,172	(492)	740
Transfers to the General Fund and Other *(Note 18)*	205	(12,498)	0	(12,293)
Total Financing Sources	**1,007**	**442,987**	**(535)**	**443,459**
Net Cost of Operations	2,764	(444,620)	535	(441,321)
Net Change	3,771	(1,633)	0	2,138
Cumulative Results of Operations	**35,385**	**13,397**	**0**	**48,782**
UNEXPENDED APPROPRIATIONS				
Beginning Balances	$ 202	$ 68,068	$ 0	$ 68,270
Budgetary Financing Sources:				
Appropriation Received *(Note 18)*	390	450,832	0	451,222
Appropriations Transferred In/Out	0	27	0	27
Other Adjustments	(2)	(143)	0	(145)
Appropriations Used	(390)	(446,667)	0	(447,057)
Total Budgetary Financing Sources	**(2)**	**4,049**	**0**	**4,047**
Total Unexpended Appropriations	**$ 200**	**$ 72,117**	**$ 0**	**$ 72,317**
Net Position	**$ 35,585**	**$ 85,514**	**$ 0**	**$ 121,099**

The accompanying notes are an integral part of these financial statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

For the Year Ended September 30, 2008

(In Millions)

	Budgetary	Non-Budgetary Financing	Total
Budgetary Resources			
Unobligated balance, brought forward	$ 57,450	$ 0	$ 57,450
Recoveries of prior year unpaid obligations	413	0	413
Budget authority:			
Appropriations *(Note 18)*	679,563	0	679,563
Borrowing authority	4	34,304	34,308
Spending Authority from Offsetting Collections			
Earned: Collected	8,705	335	9,040
Change in receivables from Federal sources	(32)	0	(32)
Change unfilled customer orders:			
Advance received	19	0	19
Without advance from Federal sources	(39)	0	(39)
Subtotal	688,220	34,639	722,859
Non-expenditure transfers, net	844	0	844
Temporarily not available pursuant to Public Law	(9)	0	(9)
Permanently not available	(4,626)	(4,767)	(9,393)
Total Budgetary Resources	**$ 742,292**	**$ 29,872**	**$ 772,164**
Status of Budgetary Resources			
Obligations incurred *(Note 20)*: Direct	$ 477,384	$ 5,415	$ 482,799
Reimbursable	4,735	0	4,735
Subtotal	482,119	5,415	487,534
Unobligated Balance: Apportioned	214,114	24,122	238,236
Exempt from apportionment	34,999	0	34,999
Subtotal	249,113	24,122	273,235
Unobligated balance not available	11,060	335	11,395
Total Status of Budgetary Resources	**$ 742,292**	**$ 29,872**	**$ 772,164**
Change in Obligated Balance			
Obligated balance, net:			
Unpaid obligations brought forward, Oct. 1	$ 57,811	$ 0	$ 57,811
Uncollected customer payments from Federal sources brought forward	(418)	0	(418)
Total unpaid obligated balance, net	**57,393**	**0**	**57,393**
Obligations incurred, net	482,119	5,415	487,534
Gross outlays	(482,199)	(5,409)	(487,608)
Recoveries of prior year unpaid obligations, actual	(413)	0	(413)
Change uncollected customer payments Federal source	71	0	71
Obligated balance, net, end of period:			
Unpaid obligations	57,318	6	57,324
Uncollected customer payments Federal sources	(347)	0	(347)
Total unpaid obligated balance, net, end of period	**56,971**	**6**	**56,977**
Net Outlays			
Gross outlays	482,199	5,409	487,608
Offsetting collections	(8,194)	(335)	(8,529)
Distributed offsetting receipts	(16,211)	0	(16,211)
Net Outlays	**$ 457,794**	**$ 5,074**	**$ 462,868**

The accompanying notes are an integral part of these financial statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

For the Year Ended September 30, 2007

(In Millions)

	Budgetary	Non-Budgetary Financing	Total
Budgetary Resources			
Unobligated balance, brought forward	$ 57,540	$ 0	$ 57,540
Recoveries of prior year unpaid obligations	474	0	474
Budget authority:			
Appropriations *(Note 18)*	465,200	0	465,200
Borrowing authority	11	0	11
Spending Authority from Offsetting Collections			
Earned: Collected	9,937	0	9,937
Change in receivables from Federal sources	(66)	0	(66)
Change unfilled customer orders: Advance received	17	0	17
Without advance from Federal sources	(125)	0	(125)
Subtotal	474,974	0	474,974
Non-expenditure transfers, net	25	0	25
Temporarily not available pursuant to Public Law	90	0	90
Permanently not available	(10,123)	0	(10,123)
Total Budgetary Resources	**$ 522,980**	**$ 0**	**$ 522,980**
Status of Budgetary Resources			
Obligations incurred *(Note 20)*: Direct	$ 460,999	$ 0	$ 460,999
Reimbursable	4,531	0	4,531
Subtotal	465,530	0	465,530
Unobligated Balance: Apportioned	13,525	0	13,525
Exempt from apportionment	32,930	0	32,930
Subtotal	46,455	0	46,455
Unobligated balance not available	10,995	0	10,995
Total Status of Budgetary Resources	**$ 522,980**	**$ 0**	**$ 522,980**
Change in Obligated Balance			
Obligated balance, net:			
Unpaid obligations brought forward, Oct. 1	$ 53,057	$ 0	$ 53,057
Uncollected customer payments from Federal sources brought forward	(609)	0	(609)
Total unpaid obligated balance, net	**52,448**	**0**	**52,448**
Obligations incurred, net	465,530	0	465,530
Gross outlays	(460,302)	0	(460,302)
Recoveries of prior year unpaid obligations, actual	(474)	0	(474)
Change uncollected customer payments Federal source	191	0	191
Obligated balance, net, end of period:			
Unpaid obligations	57,811	0	57,811
Uncollected customer payments Federal sources	(418)	0	(418)
Total unpaid obligated balance, net, end of period	**57,393**	**0**	**57,393**
Net Outlays			
Gross outlays	460,302	0	460,302
Offsetting collections	(8,192)	0	(8,192)
Distributed offsetting receipts	(16,040)	0	(16,040)
Net Outlays	**$ 436,070**	**$ 0**	**$ 436,070**

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF CUSTODIAL ACTIVITY

For the Years Ended September 30, 2008 and 2007

(In Millions)

	2008	2007
Sources of Custodial Revenue *(Note 21)*:		
Revenue Received		
Individual Income and FICA Taxes	$ 2,294,326	$ 2,201,464
Corporate Income Taxes	354,063	395,320
Estate and Gift Taxes	29,824	26,978
Excise Taxes	66,293	67,766
Railroad Retirement Taxes	4,939	4,718
Unemployment Taxes	7,331	7,416
Deposit of Earnings, Federal Reserve System	33,598	32,043
Fines, Penalties, Interest and Other Revenue	2,233	3,084
Total Revenue Received	**$ 2,792,607**	**$ 2,738,789**
Less Refunds	(426,074)	(292,684)
Net Revenue Received	**$ 2,366,533**	**$ 2,446,105**
Accrual Adjustment	3,132	5,588
Total Custodial Revenue	**$ 2,369,665**	**$ 2,451,693**
Disposition of Custodial Revenue:		
Amounts Provided to Fund Non-Federal Entities	407	486
Amounts Provided to Fund the Federal Government *(Note 21)*	2,366,126	2,445,619
Accrual Adjustment	3,132	5,588
Total Disposition of Custodial Revenue	**$ 2,369,665**	**$ 2,451,693**
Net Custodial Revenue	**$ 0**	**$ 0**

The accompanying notes are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

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1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The accompanying financial statements include the operations of the U.S. Department of the Treasury (Treasury Department), one of 24 CFO Act agencies of the Executive Branch of the United States Government, and certain custodial activities managed on behalf of the entire U.S. Government. The following paragraphs describe the activities of the reporting entity.

The Treasury Department was created by Act (1 Stat.65) on September 2, 1789. Many subsequent acts affected the development of the Treasury Department, delegating new duties to its charge and establishing the numerous bureaus and divisions that now comprise the Treasury Department. As a major policy advisor to the President, the Secretary has primary responsibility for formulating and managing the domestic and international tax and financial policies of the U.S. Government.

Further, the Secretary is responsible for recommending and implementing United States domestic and international economic and fiscal policy; governing the fiscal operations of the government; maintaining foreign assets control; managing the federal debt; collecting income and excise taxes; representing the United States on international monetary, trade, and investment issues; overseeing Departmental overseas operations; and directing the manufacturing of coins, currency, and other products for customer agencies and the public.

In September 2008, the Treasury Department began a number of emergency economic measures relating to the economy which involved various financing programs. Key initiatives effective for fiscal year 2008 involved programs concerning two Government Sponsored Enterprises (GSE), provision of a credit facility for GSEs and Federal Home Loan Banks, purchase of Mortgage Backed Securities, and setup of a Money Market Insurance Program (Notes 24 and 25).

The Treasury Department includes the Departmental Offices (DO) and nine operating bureaus. For financial reporting purposes, DO is comprised of: International Assistance Programs (IAP), Office of Inspector General (OIG), Treasury Forfeiture Fund (TFF), Exchange Stabilization Fund (ESF), Community Development Financial Institutions Fund (CDFI), Office of D.C. Pensions (DCP), Treasury Inspector General for Tax Administration (TIGTA), Federal Financing Bank (FFB), and the DO policy offices. In addition, the Air Transportation Stabilization Board (ATSB) was also part of the DO reporting entity for the year ended September 30, 2007. The ATSB was set up to administer the temporary emergency program to assist air carriers that were in need of funds as a result of the terrorist attacks on the United States that occurred on September 11, 2001. The ATSB program was terminated at September 30, 2007. To close out its remaining budgetary resources during fiscal year 2008, ATSB returned $3.5 million of unexpended appropriations to the General Fund of the United States. In fiscal year 2008 the management of the Treasury Franchise Fund was transferred from the Departmental Offices (DO) to the Bureau of the Public Debt (BPD).

The nine operating bureaus are: Office of the Comptroller of the Currency (OCC); Bureau of Engraving and Printing (BEP); Financial Crimes Enforcement Network (FinCEN); Financial Management Service (FMS); Internal Revenue Service (IRS); U.S. Mint (Mint); Bureau of the Public Debt (BPD); Office of Thrift Supervision (OTS); and the Alcohol and Tobacco Tax and Trade Bureau (TTB).

The Treasury Department's financial statements reflect the reporting of its own entity activities, which include appropriations it receives to conduct its operations and revenue generated from those operations. They also reflect the

reporting of certain non-entity (custodial) functions it performs on behalf of the U.S. Government and others. Non-entity activities include collecting of federal revenue, servicing the federal debt, disbursing certain federal funds, and maintaining certain assets and liabilities for the U.S. Government, as well as for others. The Treasury Department's reporting entity does not include the "General Fund" of the U.S. Government, which maintains receipt, disbursement, and appropriation accounts for all federal agencies.

Transactions and balances among the Treasury Department's entities have been eliminated from the Consolidated Balance Sheets, the Consolidated Statements of Net Cost, and the Consolidated Statements of Changes in Net Position.

B. Basis of Accounting and Presentation

The financial statements have been prepared from the accounting records of the Treasury Department in conformity with accounting principles generally accepted in the United States for federal entities, and the Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements,* as amended. Accounting principles generally accepted for federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB). FASAB is recognized by the American Institute of Certified Public Accountants as the official accounting standards-setting body of the U.S. Government.

These financial statements are provided to meet the requirements of the Government Management Reform Act of 1994. They consist of the Consolidated Balance Sheets, the Consolidated Statements of Net Cost, and the Consolidated Statements of Changes in Net Position, the Combined Statements of Budgetary Resources, and the Statements of Custodial Activity. The statements and the related notes are prepared in a comparative form to present both fiscal year 2008 and fiscal year 2007 information.

While these financial statements have been prepared from the books and records of the Treasury Department in accordance with the formats prescribed by OMB, these financial statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

Throughout these financial statements, intra-governmental assets, liabilities, earned revenues, and costs have been classified according to the entity for these transactions. Intra-governmental assets and liabilities are those from or to other federal entities. Intra-governmental earned revenues are collections or accruals of revenue from other federal entities, and intra-governmental costs are payments or accruals of expenditure to other federal entities.

The financial statements should be read with the realization that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

C. Tax and Other Non-Entity Receivables

Tax receivables are not accrued until related tax returns are filed or assessments are made. Prepayments of taxes are netted against liabilities. Accruals are made to reflect penalties and interest on tax receivables through the balance sheet date. Tax receivables consist of unpaid assessments (taxes and associated penalties and interest) due from taxpayers for which the Treasury Department can support the existence of a receivable through taxpayer agreement, such as filing a tax return without sufficient payment, or a court ruling in favor of the Treasury Department. Tax receivables are shown on the balance sheet net of an allowance for doubtful accounts and abatements. The allowance for doubtful accounts reflects an estimate of the portion deemed to be uncollectible based on historical experience of similar taxes receivable.

D. Inventory and Related Property

Inventories and related property include inventory, operating materials and supplies, and forfeited property. The Treasury Department values inventories at either standard cost or lower of cost or latest acquisition cost except for finished goods inventories, which are valued at weighted average unit cost. All operating materials and supplies are recorded as an expense when consumed in operations.

Forfeited property is recorded at estimated fair market value at the time of seizure as deferred revenue, and may be adjusted to reflect the current fair market value at the end of the fiscal year. Property forfeited in satisfaction of a taxpayer's assessed liability is recorded when title to the property passes to the U.S. Government and a corresponding credit is made to the related taxes receivable. Direct and indirect holding costs are not capitalized for individual forfeited assets.

Mortgages and claims on forfeited assets are recognized as a valuation allowance and a reduction of deferred revenue from forfeited assets when the asset is forfeited. The allowance includes mortgages and claims on forfeited property held for sale and a minimal amount of claims on forfeited property previously sold. Revenue from the forfeiture of property is deferred until the property is sold or transferred to a state, local or federal agency. Revenue is not recognized if the forfeited property is ultimately destroyed or cannot be legally sold.

E. Loans and Interest Receivable – Entity and Non-Entity

Intra-governmental entity Loans and Interest Receivable from other federal agencies represent loans and interest receivable held by the Treasury Department. No subsidy costs were recorded for loans purchased from federal agencies or for guaranteed loans made to non-federal borrowers, because these are guaranteed (interest and principal) by those agencies.

Intra-governmental non-entity Loans and Interest Receivable from other federal agencies represent loans issued by the Treasury Department to federal agencies on behalf of the U.S. Government. The Treasury Department acts as an intermediary issuing these loans, because the agencies receiving these loans will lend these funds to others to carry out various programs of the Federal Government. Because of the Treasury Department's intermediary role in issuing these loans, the Treasury Department does not record an allowance or subsidy costs related to these loans. Instead, loan loss allowances and subsidy costs are recognized by the ultimate lender, the federal agency that issued the loans.

F. Advances to the Black Lung Trust Fund

Advances have been provided to the Department of Labor's Black Lung Trust Fund from the General Fund of the U.S. Government. The Bureau of the Public Debt accounts for the advances on behalf of the General Fund of the U.S. Government. Advances to the Black Lung Trust Fund are being accounted for pursuant to the Benefits Revenue Act which states: "In the event that fund resources are not adequate to meet fund obligations, then, advances of interest and principal are paid to the General Fund of the U.S. Government when the Secretary of the Treasury determines that funds are available in the trust fund for such purposes." The advance to the Black Lung Trust Fund is repayable with interest at a rate determined by the Secretary of the Treasury to be equal to the current average market yield on outstanding marketable obligations of the United States with remaining periods to maturity comparable to the anticipated period during which the advance will be outstanding. Advances made prior to 1982 carried rates of interest equal to the average rate borne by all marketable interest-bearing obligations of the United States then forming a part of the public debt.

These advances were retired on October 7, 2008, under the refinancing agreement authorized by the enactment of the Energy Improvement and Extension Act of 2008 on October 3, 2008. The Act gave authority to the Black Lung Disability Trust Fund to issue obligations to the Secretary of the Treasury and gave authority to the Secretary of the Treasury to purchase the obligations. The repayable advances were retired with the proceeds from these obligations as a one time appropriation to the Trust Fund (Note 26).

G. Property, Plant, and Equipment

Property, plant, and equipment (PP&E) is composed of capital assets used in providing goods or services. It also includes assets acquired through capital leases, which are initially recorded at the amount recognized as a liability for the capital lease at its inception. PP&E is stated at full cost, including costs related to acquisition, delivery, and installation, less accumulated depreciation. Major alterations and renovations including leasehold and land improvements are capitalized, while maintenance and repair costs are charged to expenses as incurred.

Internal use software encompasses software design, development, and testing of projects adding significant new functionality and long-term benefits. Costs for developing internal use software are accumulated in work in development until a project is placed into service, and testing and final acceptance are successfully completed. Once completed, the costs are transferred to depreciable property.

Costs for construction projects are recorded as construction-in-progress until completed, and are valued at actual (direct) cost, plus applied overhead and other indirect costs.

The Treasury Department leases land and buildings from the General Services Administration (GSA) to conduct most of its operations. GSA charges a standard level users fee which approximates commercial rental rates for similar properties. Therefore, GSA-owned properties are not included in the Department's PP&E.

The Treasury Department's bureaus are diverse both in size and in operating environment. Accordingly, the Department's capitalization policy provides minimum capitalization thresholds which range from $25,000 to $50,000. The Treasury Department also uses a capitalization threshold range for bulk purchases: $250,000 to $500,000 for non-manufacturing bureaus and $25,000 to $50,000 for manufacturing bureaus. Bureaus determine the individual items that comprise bulk purchases. In addition, Treasury bureaus may expense bulk purchases if they conclude that total period costs would not be materially distorted and the cost of capitalization is not economically feasible.

Depreciation is expensed on a straight-line basis over the estimated useful life of the asset with the exception of leasehold improvements, which are depreciated over the useful life of the lease or the useful life of the improvement, whichever is shorter. Service life ranges are high due to the Treasury Department's diversity of PP&E. Construction in progress and internal use software in development are not depreciated.

The Treasury Department owns the Treasury building — a multi-use heritage asset. Multi-use heritage assets are assets of historical significance for which the predominant use is general government operations. All acquisition, reconstruction, and betterment costs for the Treasury Department building are capitalized as general PP&E and depreciated over their service life.

H. Federal Debt

Debt and associated interest are reported on the accrual basis of accounting. Interest costs are recorded as expenses when incurred, instead of when paid. Certain Treasury securities are issued at a discount or premium. These discounts and premiums are amortized over the term of the security using an interest method for all long term securities and the straight line method for short term securities. The Department of the Treasury also issues Treasury Inflation-Protected Securities (TIPS). The principal for TIPS is adjusted daily over the life of the security based on the Consumer Price Index for all Urban Consumers.

I. Pension Costs, Other Retirement Benefits, and Other Post Employment Benefits

The Treasury Department recognizes the full costs of its employees' pension benefits. However, the liabilities associated with these costs are recognized by the Office of Personnel Management (OPM) rather than the Treasury Department.

Most employees of the Treasury Department hired prior to January 1, 1984, participate in the Civil Service Retirement System (CSRS), to which the Treasury Department contributes 8.51 percent of salaries for regular CSRS employees.

On January 1, 1987, the Federal Employees' Retirement System (FERS) went into effect pursuant to Public Law 99-335. Employees hired after December 31, 1983, are automatically covered by FERS and Social Security. A primary feature of FERS is that it offers a savings plan to which the Treasury Department automatically contributes one percent of base pay and matches any employee contributions up to an additional four percent of base pay. For most employees hired after December 31, 1983, the Treasury Department also contributes the employer's matching share for Social Security. For the FERS basic benefit the Treasury Department contributes 11.2 percent for regular FERS employees.

Similar to federal retirement plans, OPM, rather than the Treasury Department, reports the liability for future payments to retired employees who participate in the Federal Employees Health Benefits Program (FEHBP) and Federal Employees Group Life Insurance (FEGLI) Program. The Treasury Department reports the full cost of providing other retirement benefits (ORB). The Treasury Department also recognizes an expense and liability for other post employment benefits (OPEB), which includes all types of benefits provided to former or inactive (but not retired) employees, their beneficiaries, and covered dependents. Additionally, the Treasury bureaus, OCC and OTS, separately sponsor certain benefit plans for their employees. OCC sponsors a defined life insurance benefit plan for current and retired employees. Additionally, OTS provides certain health and life benefits for all retired employees that meet eligibility requirements.

J. Special Drawing Rights (SDR) Certificates Issued to Federal Reserve Banks

The Exchange Stabilization Fund (ESF) was established for use by the Secretary of the Treasury to account for the purchase or sale of foreign currencies, to hold U.S. foreign exchange and Special Drawing Rights (SDR) assets, and to provide financing to foreign governments. SDR transactions of the ESF require the explicit authorization of the Secretary of the Treasury. The Special Drawing Rights Act of 1968 authorized the Secretary of the Treasury to issue certificates, not to exceed the value of SDR holdings, to the Federal Reserve Banks in return for interest free dollar amounts equal to the face value of certificates issued. The certificates may be issued to finance the acquisition of SDR from other countries or to provide resources for financing other ESF operations. Certificates issued are to be redeemed by the Treasury Department at such times and in such amounts as the Secretary of the Treasury may deter-

mine. Certificates issued to Federal Reserve Banks are stated at their face value. It is not practical to estimate the fair value of Certificates Issued to Federal Reserve Banks since these certificates contain no specific terms of repayment.

K. Federal Employee Benefits Payable - FECA Actuarial Liability

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered Federal civilian employees injured on the job, and employees who have incurred a work-related injury or occupational disease. These future workers' compensation estimates were generated from an application of actuarial procedures developed to estimate the liability for FECA benefits. The actuarial liability estimates for FECA benefits include the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases.

L. Revenue and Financing Sources

Treasury Department activities are financed either through exchange revenue it receives from others or through non-exchange revenue and financing sources (such as appropriations provided by the Congress and penalties, fines, and certain user fees collected). User fees primarily include Internal Revenue Service reimbursable costs to process installment agreements and accompanying photocopy and reproduction charges. Exchange revenues are recognized when earned; *i.e.*, goods have been delivered or services have been rendered. Non-exchange revenues are recognized when received by the respective Treasury Department collecting bureau. Appropriations used are recognized as financing sources when related expenses are incurred or assets are purchased. Revenue from reimbursable agreements is recognized when the services are provided. The Treasury Department also incurs certain costs that are paid in total or in part by other federal entities, such as pension costs. These subsidized costs are recognized on the Consolidated Statement of Net Cost, and the imputed financing for these costs is recognized on the Consolidated Statement of Changes in Net Position. As a result, there is no effect on net position. Other non-exchange financing sources such as donations and transfers of assets without reimbursements also are recognized for the period in which they occurred on the Consolidated Statement of Changes in Net Position.

The Treasury Department recognizes revenue it receives from disposition of forfeited property as non-exchange revenue on the Consolidated Statement of Changes in Net Position. The costs related to the forfeiture fund program are reported on the Consolidated Statement of Net Cost.

M. Custodial Revenues and Collections

Non-entity revenue reported on the Treasury Department's Statement of Custodial Activity includes cash collected by the Treasury Department, primarily taxes. It does not include revenue collected by other federal agencies, such as user fees and other receipts, which are remitted for general operating purposes of the U.S. Government or are earmarked for certain trust funds. The Statements of Custodial Activity is presented on the "modified accrual basis." Revenues are recognized as cash is collected. The "accrual adjustment" is the net increase or decrease, during the reporting period, in net revenue related-assets and liabilities, mainly taxes receivable. The Balance Sheets include an estimated amount for taxes receivable and payable to the General Fund of the U.S. Government at September 30, 2008 and September 30, 2007.

N. Tax Assessments and Abatements

Under Internal Revenue Code Section 6201, the Treasury Department is authorized and required to make inquiries, determinations, and assessments of all taxes which have not been duly paid (including interest, additions to the tax, and assessable penalties) under the law. Unpaid assessments result from taxpayers filing returns without sufficient

payment, as well as from tax compliance programs, such as examination, under-reporter, substitute for return, and combined annual wage reporting. The Treasury Department also has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process. Abatements may result in claims for refunds or a reduction of the unpaid assessed amount.

O. Permanent and Indefinite Appropriations

Permanent and indefinite appropriations are used to disburse tax refunds, income tax credits, and child tax credits. These appropriations are not subject to budgetary ceilings established by Congress. Therefore, refunds payable at year end are not subject to funding restrictions. Refund payment funding is recognized as appropriations are used. Permanent indefinite authority for refund activity is not stated as a specific amount and is available for an indefinite period of time. Although funded through appropriations, refund activity, in most instances, is reported as a custodial activity of the Treasury Department, since refunds are, in substance, a custodial revenue-related activity resulting from taxpayer overpayments of their tax liabilities.

The Treasury Department also receives two permanent and indefinite appropriations related to debt activity. One is used to pay interest on the public debt securities; the other is used to redeem securities that have matured, been called, or are eligible for early redemption. These accounts are not annual appropriations; and do not have refunds. Debt activity appropriations are related to the Treasury Department's liability and would be reported on the Treasury Department's Balance Sheet. Permanent indefinite authority for debt activity is available for an indefinite period of time.

Additionally, the Treasury Department receives other permanent and indefinite appropriations to make certain payments on behalf of the U.S. Government. These appropriations are provided to make payments to the Federal Reserve for services provided. They also include appropriations provided to make other disbursements on behalf of the U.S. Government, including payments made to various parties as the result of certain claims and judgments rendered against the United States.

P. Income Taxes

As an agency of the Federal Government, the Treasury Department is exempt from all income taxes imposed by any governing body, whether it is a federal, state, commonwealth, local, or foreign government.

Q. Use of Estimates

The Treasury Department has made certain estimates and assumptions relating to the reporting of assets, liabilities, revenues, expenses, and the disclosure of contingent liabilities to prepare these financial statements. Actual results could differ from these estimates. Major items subject to estimates include loan receivables (including Mortgage Backed Securities); investments in non-federal securities (including Freddie Mac and Fannie Mae); taxes receivables; depreciation; money market insurance liability; liability for liquidity commitment (Freddie Mac and Fannie Mae); imputed costs; actuarial liabilities; cost and earned revenue allocations; contingent legal liabilities; and credit reform subsidy costs (Notes 3 and 24).

The Treasury recognizes the sensitivity of credit reform modeling to slight changes in some model assumptions and uses continual review of model factors, statistical modeling, and annual re-estimates to reflect the most accurate cost of the credit programs to the U.S. Government. Two of the emergency economic programs that Treasury implemented in the latter part of September 2008, the purchase program for Mortgage Backed Securities (MBS) and the Government

Sponsored Enterprise credit line facility , both operate under the provisions of credit reform and the use of estimates as dictated by the Federal Credit Reform Act (Notes 3 and 24). Further, the assumptions underlying the estimated future liquidity payments to the GSE's are subject to a high level of market volatility, such that actual future payments may differ significantly from current estimates due to changing circumstances. The Troubled Asset Relief Program described further in subsequent event Note 26 will also require the use of sophisticated estimates.

The Treasury used the following methodologies for valuation of the investment in GSE:

Common Stock Warrants: The Black-Scholes Option Model (1973) was used to affirm that the value of the warrants is insensitive to the usual option input variables, including time to expiration and stock volatility, and that the value per warrant share is nominally less than the trading price at September 30, 2008.

Senior Preferred Stock: These shares were valued based on an interpolation of market prices during the five trading days prior to the announcement of the Keepwell Agreement for (i) Fannie Mae and Freddie Mac subordinated debt, as adjusted for the tax advantages of stock dividends compared with taxable interest, and (ii) Fannie Mae and Freddie Mac preferred stock.

R. Credit Risk

Credit risk is the potential, no matter how remote, for financial loss from a failure of a borrower or a counter party to perform in accordance with underlying contractual obligations. The Treasury Department takes on possible credit risk when it makes direct loans or credits to foreign entities or becomes exposed to institutions which engage in financial transactions with foreign countries. Given the history of the Treasury Department with respect to such exposure and the financial policies in place in the U. S. Government and other institutions in which the United States participates, the Treasury Department expectations of credit losses is nominal.

The Treasury Department also takes on credit risk related to committed but undisbursed direct loans, its liquidity commitment to Government Sponsored Enterprises, its mortgage-backed securities portfolio, its insurance of non-FDIC insured money market funds, and its Terrorism Risk Insurance Program. Except for the Terrorism Risk Insurance Program, these activities focus on the underlying problems in the credit markets, and the ongoing turbulence in those markets exposes the Department to potential costs and losses. The extent of the risk assumed by the Treasury Department is described in more detail in the notes to the financial statements, and where applicable factored into credit reform models.

S. Earmarked Funds

Treasury has accounted for revenues and other financing sources for earmarked funds separately from other funds. This method was adopted in accordance with the provisions of the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds*, which became effective October 1, 2007. This standard amended SFFAS No. 7, *Revenue and Other Financing Sources*, by:

- Elaborating the special accountability needs associated with dedicated collections;
- Separating dedicated collections into two categories – earmarked funds and fiduciary activity; and
- Defining, and providing accounting and reporting guidance for earmarked funds.

Earmarked funds are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities or purposes. SSFAS No. 27 defines the following three criteria for deter-

mining an earmarked fund: (1) A statute committing the Federal Government to use specifically identified revenues and other financing sources not used in the current period for future use to finance the designated activities, benefits, or purposes; (2) Explicit authority for the earmarked fund to retain revenues and other financing sources not used in the current period for future use to finance the designated activities, benefits, or purposes; and (3) A requirement to account for and report on the receipt, use, and retention of the revenues and other financing sources that distinguished the earmarked fund from the Federal Government's general revenues.

T. Allocation Transfers

The Treasury Department is a party to allocation transfers with other federal agencies as both a transferring (parent) entity and/or a receiving (child) entity. Allocation transfers are legal delegations by one department of its authority to obligate budget authority and outlay funds to another department. A separate fund account (allocation account) is created in the U.S. Treasury as a subset of the parent fund account for tracking and reporting purposes. All allocation transfers of balances are credited to this account, and subsequent obligations and outlays incurred by the child entity are charged to this allocation account as they execute the delegated activity on behalf of the parent. Beginning in fiscal year 2007, parent federal agencies report both the proprietary and budgetary activity and the child agency does not report any financial activity related to budget authority allocated from the parent federal agency to the child federal agency. The Treasury Department had no significant allocation transfers to report in fiscal years 2008 and 2007.

The Treasury Department allocates funds, as the parent, to the Department of Energy. OMB allows certain exceptions to allocation reporting for certain funds. Accordingly, the Treasury Department has reported certain funds for which the Treasury Department is the child in the allocation transfer, but in compliance with OMB Circular No. A-136 (see II.4.2 question 5 for three exceptions), will report all activities relative to these allocation transfers in the Treasury Department's financial statements. The Treasury Department receives allocation transfers, as the child, from the Agency for International Development.

U. Credit Reform Accounting

The authoritative guidance for the credit reform portion of these statements are contained primarily in SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees,* as amended by SFFAS No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees,* SFFAS No. 19, *Technical Amendments to Accounting Standards for Direct Loans and Loan Guarantees.* This guidance was promulgated as a result of the Federal Credit Reform Act (FCRA) of 1990.

The FCRA requires that the ultimate costs of a credit program be calculated, and the budgetary resources obtained, before the direct loan obligations are incurred. The cost of loan guarantee programs is the net present value of the estimated future cash flows from payments (for claims, interest rate subsidies). The primary purpose of the FCRA, which became effective on October 1, 1991, is to more accurately measure the cost of federal credit programs and to place the cost of such credit programs on a basis equivalent with other federal spending.

SFFAS No. 2, which generally mirrors the requirements of the FCRA, established guidance for estimating the cost of direct and guaranteed loan programs, as well as for recording direct loans and liability for loan guarantees for financial reporting purposes. SFFAS No. 2 states that the actual and expected costs of federal credit programs should be fully recognized in both budgetary and financial reporting. To accomplish this, agencies first predict or estimate the future performance of direct and guaranteed loans when preparing their annual budgets. The data used for these budgetary estimates are re-estimated after the fiscal year-end to reflect changes in actual loan performance and actual interest

rates in effect when the loans were issued. The re-estimate data are then used to report the cost of the loans disbursed under the direct or guaranteed loan program as a "Program Cost" in the agencies' Statement of Net Cost.

The FCRA establishes budgetary and financing control for each credit program through the use of the program, financing and negative subsidy receipt accounts for direct loans obligated after September 30, 1991. The FCRA establishes the use of the program, financing, and general fund receipt for direct loans obligated after September 30, 1991 (Credit Reform). These accounts are classified as either budgetary or non-budgetary in the Combined Statements of Budgetary Resources. The budgetary accounts include the program accounts and receipt accounts. The non-budgetary accounts consist of the credit reform financing accounts.

The program account is a budget account that receives and obligates appropriations to cover the subsidy cost of a direct loan or guarantee and disburses the subsidy cost to the financing account. The program account also receives appropriations for administrative expenses. The financing account is a non-budgetary account that records all of the cash flows resulting from Credit Reform direct loans or loan guarantees. It disburses loans, collects repayments and fees, makes claim payments, holds balances, borrows from U.S. Treasury Bureau of the Public Debt, earns or pays interest, and receives the subsidy cost payment from the program account.

The general fund receipt account is a budget account used for the receipt of amounts paid from the financing account when there is a negative subsidy from the original estimate or a downward re-estimate. In most cases, the receipt account is a general fund receipt account and amounts are not earmarked for the credit program. They are available for appropriations only in the sense that all general fund receipts are available for appropriations. Any assets in this account are non-entity assets and are offset by intragovernmental liabilities. At the beginning of the following fiscal year, the fund balance in the general fund receipt account is transferred to the U.S. Government General Fund.

V. Investments

Treasury records investments in non-federal financial securities at acquisition cost at the date of purchases in accordance with OMB A-136. Disclosure of market values are made as of year end and any permanent impairment is recorded.

2. FUND BALANCE

Fund Balance with Treasury is the aggregate amount of the Treasury Department's accounts with the U.S. Government's central accounts from which the Treasury Department is authorized to make expenditures and pay liabilities. It is an asset because it represents the Treasury Department's claim to the U.S. Government's resources. Fund balance with Treasury is not equivalent to unexpended appropriations, because it also includes non-appropriated revolving and enterprise funds, suspense accounts, and custodial funds such as deposit funds, special funds, and trust funds.

Fund Balances: As of September 30, 2008 and September 30, 2007, fund balances consisted of the following (in millions):

	2008	2007
Appropriated Funds (see Note 24)	$ 272,561	$ 72,897
Revolving Funds	1,837	912
Trust Funds	2	8
Clearing Funds	26	10
Deposit Funds	587	542
Special Funds	299	395
Other Funds (Receipts and Suspense Funds)	56	3
Total Fund Balances	**$ 275,368**	**$ 74,767**

As of September 30, 2008 and September 30, 2007, the status of fund balances consisted of the following (in millions):

Status of Fund Balance with Treasury	2008	2007
Unobligated Balance – Available (see Note 24)	$ 242,939	$ 17,843
Unobligated Balance – Unavailable	11,395	10,995
Obligated Balance not yet Disbursed	56,868	57,310
Subtotal	**$ 311,202**	**$ 86,148**
Adjustment for Non-Budgetary Funds	669	556
Adjustment for Borrowing Authority	(29,810)	(5,716)
Adjustment for Intra-Treasury Investments	(5,530)	(5,280)
Adjustment for Imprest Funds	(4)	(4)
Adjustment for Other Budgetary Resources Not in Fund Balance – Cash and Other Assets	(4,838)	(4,616)
Authority Unavailable for Obligation	3,679	3,679
Total Status of Fund Balance	**$ 275,368**	**$ 74,767**

For ESF, the above balances only include unobligated balances related to the ESF insurance program that began in fiscal year 2008. Otherwise, ESF does not have Fund Balance with Treasury. Accordingly, while other ESF balances are included on the Statement of Budgetary Resources (SBR), they are not a component of Fund Balance with Treasury. The ESF balances displayed on the SBR include components of cash, foreign currency, and other monetary assets (Note 5).

As of September 30, 2008 and September 30, 2007, the Treasury Department did not have any budgetary authority in Fund Balance with Treasury that was specifically withheld from apportionment by OMB. The balances in non-entity funds, such as deposit funds, are being held in a fiduciary capacity by the Treasury Department for the public or for another federal entity, such as the General Fund of the U.S. Government. Such funds have an offsetting liability equal to fund balance. See Note 8 regarding restrictions related to the line of credit held on the U.S. Quota in the International Monetary Fund.

3. LOANS, INTEREST RECEIVABLE AND CREDIT PROGRAM RECEIVABLES - MORTGAGE BACKED SECURITIES

Loans and Interest Receivable:

As of September 30, 2008 and September 30, 2007, intra-governmental loans (issued by the FFB) and interest receivable consisted of the following (in millions):

Entity Intra-governmental:

	Loans Receivable	Interest Receivable	2008 Total	Loans Receivable	Interest Receivable	2007 Total
Executive Office of the President	$ 680	$ 8	$ 688	$ 836	$ 9	$ 845
Department of Agriculture	26,326	50	26,376	25,604	300	25,904
United States Postal Service	7,200	1	7,201	4,200	3	4,203
General Services Administration	2,098	37	2,135	2,151	38	2,189
Department of Housing and Urban Development	691	84	775	791	96	887
Department of Education	338	3	341	315	4	319
Department of Defense	17	0	17	70	1	71
National Credit Union Administration	1,109	0	1,109	0	0	0
Other Agencies	18	0	18	25	1	26
Subtotal-Entity	**$ 38,477**	**$ 183**	**$ 38,660**	**$ 33,992**	**$ 452**	**$ 34,444**

The FFB issues the above loans to federal agencies for their own use or to private sector borrowers, whose loans are guaranteed by the federal agencies. When a federal agency has to honor its guarantee because a private sector borrower defaults, the federal agency that guaranteed the loan must obtain an appropriation or use other resources to repay the FFB. Loan principal and interest are backed by the full faith and credit of the U.S. Government, except for loans to the U.S. Postal Service. The FFB has not incurred and does not expect to incur any credit-related losses on its loans and accordingly, has not recorded an allowance for uncollectable intra-governmental loans.

Non-Entity Intra-governmental:

	Loans Receivable	Interest Receivable	2008 Total	Loans Receivable	Interest Receivable	2007 Total
Department of Agriculture	$ 51,192	$ 9	$ 51,201	$ 49,133	$ 64	$ 49,197
Department of the Interior	323	393	716	345	513	858
Federal Communications Commission	113	0	113	106	0	106
Department of Veterans Affairs	1,575	0	1,575	1,047	27	1,074
Railroad Retirement Board	3,096	69	3,165	2,945	73	3,018
Small Business Administration	9,463	0	9,463	11,366	0	11,366
Department of Housing and Urban Development	4,832	0	4,832	4,573	0	4,573
Department of Energy	2,186	20	2,206	2,241	(8)	2,233
Department of Education	128,331	0	128,331	103,973	0	103,973
Export Import Bank of the U. S.	2,929	0	2,929	4,364	0	4,364
Department of Homeland Security	17,360	359	17,719	17,787	367	18,154
Other Agencies	3,944	0	3,944	3,545	27	3,572
Subtotal Non-Entity	**$ 225,344**	**$ 850**	**$ 226,194**	**$ 201,425**	**$ 1,063**	**$ 202,488**
Total Intra-governmental Loans and Interest Receivable Entity and Non-Entity			**$ 264,854**			**$ 236,932**

BPD accounts for and reports on the principal borrowings from and repayments to the General Fund of the United States for approximately 80 funds managed by other federal agencies, as well as the related interest due to the General Fund. These agencies are statutorily authorized to borrow from the General Fund, through BPD, to make loans for a broad range of purposes, such as education, housing, farming, and small business support.

Entity and Non-Entity Non-Federal:

As of September 30, 2008 and September 30, 2007, loans and interest receivable from non-federal entities consisted of the following (in millions):

	Entity	Non-entity	2008 Total	Entity	Non-entity	2007 Total
Direct Loans	$ 62	$ 128	$ 190	$ 63	$ 131	$ 194
Interest Receivable	0	2	2	1	2	3
Less: Allowance and Subsidy Cost	(20)	0	(20)	(22)	0	(22)
Total Non-Federal Loans and Related Interest Receivable	**$ 42**	**$ 130**	**$ 172**	**$ 42**	**$ 133**	**$ 175**

Other amounts include certain loans and credits issued by the United States to various foreign governments. The agreements with each debtor government vary as to dates, interest rates, method of payment, and billing procedures. All such loans and credits represent legally valid and outstanding obligations of foreign governments, and the U.S. Government has not waived or renounced its rights with respect to any of them. The loans are due and payable in U.S. denominations.

Credit Program Receivables

In fiscal year 2008, the Treasury Department began a program to support the availability of mortgage financing for millions of Americans and to mitigate pressures on mortgage rates. Under this program, Treasury purchases GSE MBS in the open market (note 24). This program is accounted for under credit reform accounting.

MBS Purchase Program:

Congress granted Treasury authority to purchase mortgage-backed securities (MBS) issued by Government Sponsored Enterprises (GSEs) in the Housing and Economic Recovery Act of 2008. The authority expires on December 31, 2009. To promote stability in the mortgage market, Treasury's makes MBS purchases in the open market. GSE MBS are credit-guaranteed by the GSEs and Treasury plans to hold its portfolio of MBS to maturity unless, based on mortgage market conditions, sales are necessary. This program was implemented to help improve the availability of mortgage credit to American homebuyers and mitigate pressures on mortgage rates. By purchasing these securities, Treasury seeks to broaden access to mortgage funding for current and prospective homeowners as well as to promote market stability. The scale of the program will be based on developments in the capital markets and housing markets.

The MBS program is accounted for under the provisions of the Federal Credit Reform Act, section 13201 of the Omnibus Budget Reconciliation Act of 1990, P.L. No. 101-508, dated November 5, 1990. Treasury develops subsidy estimates, re-estimates, and rates based on anticipated cash flows from the purchases of MBS. Factors that impact these cash flows and the subsidy rate include the interest coupons on the securities, the discount or premium paid at the time of purchase, the speed of mortgage prepayments, and the probability of GSE failure. A positive subsidy reflects the cost to the Government of the program and a negative subsidy reflects earnings on the program. The

fiscal year 2008 GSE MBS subsidy rate was negative, indicating Treasury expects to earn a return on its investments in these securities.

As of September 30, 2008, the Treasury agent responsible for MBS purchases was in receipt of $1,689 million that was recorded as an advance which accounts for the increase, in other assets, in fiscal year 2008 to $1,714 million. This amount was to purchase MBS, however, the purchases were not made until after September 30, 2008.

GSE Credit Facility program:

Congress granted Treasury authority to make credit available to GSE in the Housing and Economic Recovery Act of 2008. The GSE credit facility program (GSECF) will offer liquidity if needed until December 31, 2009. This will ensure credit availability to the GSEs and provide secured funding on an as needed basis under terms and conditions established by the Treasury Secretary to protect taxpayers. Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are eligible to borrow under this program if needed. Funding will be provided directly by Treasury in exchange for eligible collateral from the GSEs which will be limited to guaranteed mortgage-backed securities issued by Freddie Mac and Fannie Mae as well as advances made by the Federal Home Loan Banks. All such assets pledged against loans will be accepted with appropriate collateral margins as determined by Treasury. Loan requests will require approval from Treasury and verification that adequate collateral has been pledged.

The GSECF program is accounted for under the provisions of the Federal Credit Reform Act, section 13201 of the Omnibus Budget Reconciliation Act of 1990, P.L. No. 101-508, dated November 5, 1990. Treasury develops subsidy estimates, re-estimates, and rates based on anticipated cash flows from the credit facility. Factors that impact these cash flows and the subsidy rate include the interest rate on loans and the probability of GSE failure. A positive subsidy reflects the cost to the Government of the program and a negative subsidy reflects earnings on the program. The GSECF was not utilized in fiscal year 2008 and no loans were made.

Direct MBS Purchase Program and GSE Credit Facility Obligated *(in millions)*:

Programs	Loan Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost (Present Value)	Value of Assets Related to Direct Loan
MBS	$ 3,311	$ 0	$ 0	$ 74	$ 3,385
Credit Facility	0	0	0	0	0
Total Obligated	**$ 3,311**	**$ 0**	**$ 0**	**$ 74**	**$ 3,385**

Total amount of MBS purchases and GSE Credit Facility Disbursed *(in millions)*:

Programs	Current Year
MBS	$ 3,311
Credit Facility	0
Total Obligated	$ **3,311**

Subsidy Expense Fiscal Year 2008 *(in millions)*:

Programs	Interest Differential	Defaults	Fees and Other Collections	Other	Total
MBS	$ (62)	$ 8	$ 0	$ 0	$ (54)
Credit Facility	0	0	0	0	0
Total Subsidy Expense	**$ (62)**	**$ 8**	**$ 0**	**$ 0**	**$ (54)**

Total MBS Purchases and GSE Credit Facility Subsidy Expense *(in millions)*:

Programs	Fiscal Year 2008
MBS	$ (54)
Credit Facility	0
Total	$ **(54)**

Subsidy Rates for MBS Purchases and GSE Credit Facility, Budget subsidy rates for programs in the current year cohorts *(in dollars)*:

Programs	Interest Differential	Defaults	Fees and Other Collections	Other	Total
MBS, Cohort 2008	$ (1.86)	$ 0.24	$ 0	$ 0	$ (1.62)
Credit Facility	0	0	0	0	0
Total Subsidy rates	**$ (1.86)**	**$ 0.24**	**$ 0**	**$ 0**	**$ (1.62)**

Schedule for Reconciling Subsidy Cost Allowance Balances *(in millions)*:

	2008
Beginning Balances, Changes, and Ending Balance	
Beginning Balance of the subsidy cost allowance	$ 0
Add: subsidy expense for disbursements:	
(a) Interest rate differential cost	(62)
(b) Default Costs (net of recoveries)	8
(c) Fees and other collections	0
(d) Other subsidy costs	0
Total of the above subsidy expense components	(54)
Adjustments:	
(a) Loan Modifications	0
(b) Fees received	0
(c) Foreclosed property acquired	0
(d) Loans written off	0
(e) Subsidy allowance amortized	(20)
Ending Balance subsidy cost allowance before re-estimates	(74)
Add or subtract subsidy re-estimates by component:	
(a) Interest rate re-estimate	0
(b) Technical default re-estimate	0
Total of the above re-estimate components	0
Ending balance of the subsidy cost allowance	**$ (74)**

4. DUE FROM THE GENERAL FUND AND DUE TO THE GENERAL FUND

The Treasury Department is responsible for managing various assets and liabilities on behalf of the U.S. Government as a whole. Due from the General Fund represents amounts required to fund liabilities managed by Treasury on behalf of the U.S. Government. Liabilities managed by the Treasury Department are comprised primarily of the federal debt. Due to the General Fund represents assets held for the General Fund of the U.S. Government.

As of September 30, 2008 and September 30, 2007, Due from and Due to the General Fund, included the following non-entity assets and liabilities (in millions):

Liabilities Requiring Funding from the General Fund:	2008	2007
Federal Debt and Interest Payable	$ 5,812,694	$ 5,054,250
Federal Debt and Interest Payable - Intra-governmental	4,262,414	3,974,788
Refunds Payable	3,076	1,684
Adjustment for Eliminated Liabilities	22,579	21,902
Total Due from the General Fund	**$ 10,100,763**	**$ 9,052,624**
Assets to be Distributed to the General Fund:		
Fund Balance	$ 215	$ 222
Advances to the Black Lung Trust Fund	10,484	10,058
Cash Held by the Treasury (Note 5)	364,594	70,347
Foreign Currency	31	91
Custodial Gold and Silver held by the U.S. Mint without certificates	25	25
Loans and Interest Receivable - Intra-governmental	226,194	202,488
Loans and Interest Receivable	130	133
Investments in GSEs (Note 24)	7,032	0
Accounts Receivable - Intra-governmental	372	368
Tax and Other Non-Entity Receivables	30,489	27,395
Miscellaneous Assets	12	9
Adjustment for Eliminated Assets	27,534	17,837
Total Due to the General Fund	**$ 667,112**	**$ 328,973**

The Adjustment for Eliminated Intra-Treasury liabilities mainly represents investments in U.S. Government securities held by Treasury reporting entities that were eliminated against Federal Debt and Interest Payable. The Adjustment for Eliminated Intra-Treasury assets mainly represents loans and interest payable owed by reporting entities that are consolidated with Treasury, which were eliminated against Loans and Interest Receivable held by the Bureau of the Public Debt.

On the Balance Sheet, Treasury reported $30,878 million in Tax, Other, and Related Interest Receivables as of September 30, 2008 ($27,559 million as of September 30, 2007). However, only $30,489 million is reported as Due to the General Fund of the U.S. Government ($27,395 million as of September 30, 2007). The difference is attributable to the exclusion of amounts which will be paid to others outside the U.S. Government, and miscellaneous entity receivables (Note 10).

5. CASH, FOREIGN CURRENCY, AND OTHER MONETARY ASSETS

Cash, foreign currency, and other monetary assets held as of September 30, 2008 and September 30, 2007 were as follows (in millions):

Entity:		2008		2007
Cash	$	19	$	32
Foreign Currency		12,758		12,081
Other Monetary Assets:				
Special Drawing Rights		9,464		9,363
Other		88		153
Subtotal - Entity	**$**	**22,329**	**$**	**21,629**
Non-Entity:				
Operating Cash of the U.S. Government (see Note 24)	$	364,273	$	69,701
Foreign Currency		31		91
Miscellaneous Cash held by all Treasury sub-components		637		909
Subtotal - Non-Entity	**$**	**364,941**	**$**	**70,701**
Total Cash, Foreign Currency, and Other Monetary Assets	**$**	**387,270**	**$**	**92,330**

Non-entity Operating Cash and Other Cash of the U.S. Government held by Treasury disclosed above consisted of the following (in millions):

		2008		2007
Operating Cash of the U.S. Government	$	39,209	$	69,797
Operating Cash - Federal Reserve Account (see Note 24)		332,480		5,539
Subtotal	**$**	**371,689**	**$**	**75,336**
Outstanding Checks		(7,416)		(5,635)
Total Operating Cash of the U.S. Government		**364,273**		**69,701**
Other Cash		386		700
Subtotal		**364,659**		**70,401**
Amounts Due to the Public		(65)		(54)
Total Cash Due to the General Fund (See Note 4)	**$**	**364,594**	**$**	**70,347**

Entity

Entity cash, foreign currency, and other monetary assets primarily include Foreign Currency Denominated Assets (FCDA), Special Drawing Rights (SDR), and forfeited cash. SDR and FCDA are valued as of September 30, 2008 and September 30, 2007, using current exchange rates plus accrued interest, at September 30, 2008 and 2007. "Other" includes U.S. dollars restricted for use by the International Monetary Fund (IMF), which are maintained in two accounts at the Federal Reserve Bank of New York.

The foreign currency holdings are normally invested in interest bearing securities issued by or held through foreign governments or monetary authorities. FCDA with original maturities of three months or less, were valued at $9.3 billion as of September 30, 2008 ($7.6 billion as of September 30, 2007). Other FCDA with maturities greater than three months are also held. As of September 30, 2008, FCDA with maturities greater than three months were valued at $3.5 billion ($4.5 billion as of September 30, 2007).

The SDR are international reserve assets created by the IMF. It was created as a supplement to existing reserve assets and on several occasions SDR have been allocated by the IMF to members participating in the IMF's SDR department. The SDR value as reserve assets derive, essentially, from the commitments of participants to hold and accept SDR and to honor various obligations connected with their proper functioning as a reserve asset.

The Special Drawing Rights Act of 1968 authorizes the Secretary of the Treasury to issue certificates, not to exceed the value of SDR holdings, to the Federal Reserve Bank in return for interest free dollar amounts equal to the face value of certificates issued. The certificates may be issued for the purpose of financing the acquisition of SDR from other countries or to provide resources for the financing of the Treasury Department's ESF activities. Certificates issued are to be redeemed by the Treasury Department at such times and in such amounts as the Secretary of the Treasury may determine. As of September 30, 2008, the value of the certificates issued to Federal Reserve Banks amounted to $2.2 billion ($2.2 billion as of September 30, 2007).

On a daily basis, the IMF calculates the value of the SDR using the market value, in terms of the U.S. dollar, from the amounts of each of four freely usable weighted currencies, as defined by the IMF. These currencies are the U.S. dollar, the European euro, the Japanese yen, and the British pound sterling. Treasury's SDR holdings (assets resulting from various SDR related activities including remuneration received on interest earned on the U.S. reserve position – see Note 8) and allocations from the IMF (liabilities of the U.S. coming due only in the event of a liquidation of, or U.S. withdrawal from the SDR department of the IMF, or cancellation of SDR) are revalued monthly based on the SDR valuation rate calculated by the IMF.

Pursuant to the IMF Articles of Agreement, SDR allocated to or otherwise acquired by the United States are permanent resources unless:

a. canceled by the Board of Governors based on an 85 percent majority decision of the total voting power of the Executive Board of the IMF
b. the SDR Department of the IMF is liquidated
c. the IMF is liquidated or
d. the United States chooses to withdraw from the IMF or terminate its participation in the SDR Department.

Except for the payment of interest and charges on SDR allocations to the United States, the payment of the Treasury Department's commitment related to SDR allocations is conditional on events listed above, in which the United States has a substantial or controlling voice. Allocations of SDR were made on January 1, 1970, 1971, 1972, 1979, 1980, and 1981. Since 1981, the IMF has made no further allocations of SDR. As of September 30, 2008, the amount of SDR holdings of the United States was the equivalent of $ 9.4 billion and the amount of SDR allocations to the United States was the equivalent of $ 7.6 billion. As of September 30, 2007, the amount of SDR holdings of the United States was the equivalent of $ 9.3 billion and the amount of SDR allocations to the United States was the equivalent of $7.6 billion.

During fiscal year 2008, the Treasury Department received remuneration on the U.S. reserve position in the IMF, at the prevailing rates, in the amount of $59 million equivalent of SDR ($107 million equivalent of SDR during fiscal year 2007), and paid the General Fund of the Federal Government $0.01 million ($0.5 million in fiscal year 2007) in interest on these funds until they were transferred to the General Fund.

Non-Entity

Non-entity cash, foreign currency, and other monetary assets include the Operating Cash of the U.S. Government, managed by the Treasury Department. Also included is foreign currency maintained by various U.S. and military disbursing offices. It also includes seized monetary instruments, undistributed cash, and offers in compromises which are maintained as the result of the Treasury Department's tax collecting responsibilities.

The Operating Cash of the U.S. Government represents balances from tax collections, other revenues, federal debt receipts, and other various receipts net of checks outstanding, which are held in the Federal Reserve Banks, foreign and domestic financial institutions, and in U.S. Treasury tax and loan accounts at commercial banks.

On September 18, 2008, the BPD began issuing specific cash management bills to fund the Supplementary Financing Program (SFP). The SFP is a temporary program that was announced by the Treasury Department and the Federal Reserve on September 17, 2008. The purpose of the program is to provide emergency cash for the Federal Reserve initiatives aimed at addressing the ongoing crisis in financial markets. As of September 30, 2008, there were a total of eight cash management bills outstanding that totaled $300 billion (Notes 14, 24, and 25).

Operating Cash of the U.S. Government is either insured (for balances up to $100,000), as of September 30, 2008, by the Federal Deposit Insurance Corporation (FDIC) or collateralized by securities pledged by the depository institutions and held by the Federal Reserve Banks, or through securities held under reverse repurchase agreements.

6. GOLD AND SILVER RESERVES, AND GOLD CERTIFICATES ISSUED TO FEDERAL RESERVE BANKS

The Treasury Department is responsible for safeguarding most of the U.S. Government's gold and silver reserves in accordance with 31 USC 5117. The consolidated Balance Sheets also reflect the value of the gold being held in the Federal Reserve Bank of New York (FRBNY).

Gold reserves being held by the Treasury Department are offset by a liability for gold certificates issued by the Secretary of the Treasury to the Federal Reserve as provided in 31 USC 5117. Since 1934, Gold Certificates have been issued in non-definitive or book-entry form to the Federal Reserve. The Treasury Department's liability incurred by issuing the Gold Certificates is limited to the gold being held by the Treasury Department at the legal standard value established by law. Upon issuance of Gold Certificates to the Federal Reserve, the proceeds from the certificates are deposited into the operating cash of the U.S. Government. All of the Treasury Department's certificates issued are payable to the Federal Reserve.

The deep storage gold and silver reserves are reported at the values stated in 31 U. S. C. § 5116 and § 5117 (statutory rates) which are $42.2222 per fine troy ounce (FTO) of gold and no less than $1.292929292 per FTO of silver. Accordingly, the silver is valued at $1.292929292 per FTO. The gold and silver reserves are in the custody of the U.S. Mint and FRBNY. The U.S. Mint holds gold and silver reserves without certificates (Note 4). As of September 30, 2008 and September 30, 2007, the gold and silver reserves consisted of the following (in millions):

	FTOs	Statutory Rate	9/30/08 Statutory Value	Market Rate	9/30/08 Market Value
Gold	248,046,116	$ 42.2222	$ 10,473	$ 884.50	$ 219,397
Gold Held by Federal Reserve	13,452,784	42.2222	568	884.50	11,899
Subtotal - Gold	**261,498,900**		**$ 11,041**		**$ 231,296**
Silver	16,000,000	$ 1.292929292	$ 21	$ 12.96	$ 207
Total Gold and Silver Reserves			**$ 11,062**		**$ 231,503**

	FTOs	Statutory Rate	9/30/07 Statutory Value	Market Rate	9/30/07 Market Value
Gold	248,046,116	$ 42.2222	$ 10,473	$ 743.00	$ 184,298
Gold Held by Federal Reserve	13,452,784	42.2222	568	743.00	9,996
Subtotal - Gold	**261,498,900**		**$ 11,041**		**$ 194,294**
Silver	16,000,000	$ 1.292929292	$ 21	$ 13.65	$ 218
Total Gold and Silver Reserves			**$ 11,062**		**$ 194,512**

7. INVESTMENTS AND RELATED INTEREST

Investments in U.S. Government securities held by Treasury Department entities have been eliminated against the federal debt liability for financial reporting purposes (Note 4). The ESF holds most of the Treasury Department's other investments. Securities that the Treasury Department has both the positive intent and ability to hold to maturity are classified as investment securities held to maturity and are carried at historical cost, adjusted for amortization of premiums and accretion of discounts. Foreign investment holdings are normally invested in interest bearing securities issued or held through foreign governments or monetary authorities (Note 5).

As of September 30, 2008 and September 30, 2007, entity investments in foreign investment holdings consisted of the following (in millions):

Type of Investment	Cost/ Acquisition Value	Unamortized (Premium)/ Discount	Net Investment	Interest Receivable	9/30/08 Investment Balance	9/30/08 Market Value
Euro Bonds & Notes	$ 4,477	$ 29	$ 4,506	$ 115	$ 4,621	$ 4,641
Japanese Government Bonds	5,908	3	5,911	11	5,922	5,935
Other Investments	39	(6)	33	0	33	33
Total Non-Federal	**$ 10,424**	**$ 26**	**$ 10,450**	**$ 126**	**$ 10,576**	**$ 10,609**

Type of Investment	Cost/ Acquisition Value	Unamortized (Premium)/ Discount	Net Investment	Interest Receivable	9/30/07 Investment Balance	9/30/07 Market Value
Euro Bonds & Notes	$ 4,338	$ 52	$ 4,390	$ 113	$ 4,503	$ 4,462
Japanese Government Bonds	5,520	9	5,529	8	5,537	5,538
Other Investments	40	(6)	34	0	34	34
Total Non-Federal	**$ 9,898**	**$ 55**	**$ 9,953**	**$ 121**	**$ 10,074**	**$ 10,034**

On September 7, 2008 the Treasury Department entered into senior preferred stock purchase agreements with each GSE. In exchange for entering into these agreements, Treasury Department initially received from each GSE: (1) 1,000,000 shares of non-voting variable liquidation preference senior preferred stock with a liquidation preference value of $1,000 per share and (2) warrants for the purchase at a nominal cost of 79.9percent of common stock on a fully-diluted basis. The warrants expire on September 7, 2028 (Note 24). The GSE preferred stock and warrants for common stock were valued (Notes 1Q and 24) as of the initial date at cost of $7,032 million and also valued at September 30, 2008 at $12,374 million. As of September 30, 2008, GSE investments consisted of the following (in millions):

GSE Investment	Cost/ Appraisal Value	Unamortized (Premium) Discount	Net Investment	Interest Receivable	9/30/08 Investment Balance	9/30/08 Appraisal Value
Fannie Mae Sr. Preferred Stock	$ 840	$ 0	$ 840	$ 0	$ 840	$ 741
Freddie Mac Sr. Preferred Stock	824	0	824	0	824	727
Fannie Mae Warrants Common Stock	3,104	0	3,104	0	3,104	6,507
Freddie Mac Warrants Common Stock	2,264	0	2,264	0	2,264	4,399
Total GSE Investment	**$ 7,032**	**$ 0**	**$ 7,032**	**$ 0**	**$ 7,032**	**$ 12,374**

8. RESERVE POSITION IN THE INTERNATIONAL MONETARY FUND

The United States participates in the IMF through a quota subscription. Quota subscriptions are paid partly through the transfer of reserve assets, such as foreign currencies or SDR, which are international reserve currency assets created by the IMF, and partly by making domestic currency available as needed through a non-interest-bearing letter of credit. This letter of credit, issued by the Treasury Department and maintained by the FRBNY, represents the bulk of the IMF's holdings of dollars. Approximately one quarter of one percent of the U.S. quota is maintained in cash balances in an IMF account at FRBNY.

While resources for transactions between the IMF and the United States are appropriated, they do not result in net budgetary outlays. This is because U.S./IMF quota transactions constitute an exchange of monetary assets in which the United States receives an equal offsetting claim on the IMF in the form of an increase in the U.S. reserve position in the IMF, which is interest-bearing and can be drawn at any time for balance of payments needs. When the IMF draws dollars from the letter of credit to finance its operations and expenses, the drawing does not represent a net budget outlay on the part of the United States because there is a commensurate increase in the U.S. reserve position. When the IMF repays dollars to the United States, no net budget receipt results because the U.S. reserve position declines concurrently in an equal amount.

As of September 30, 2008 and 2007, the U.S. quota in the IMF was 37.1 billion SDR, valued at approximately $57.8 billion. The quota consisted of the following (in millions):

	2008	2007
Letter of Credit [1]	$ 53,012	$ 53,212
U.S. Dollars Held in Cash by the IMF [1]	88	152
Reserve Position [2]	4,750	4,464
U.S. Quota in the IMF	**$ 57,850**	**$ 57,828**

[1] *This amount is included in entity appropriated funds under Note 2, Fund Balance with Treasury, and unexpended appropriations – Obligations/ Undelivered orders.*

[2] *This amount is included in the Cumulative Results of Operations.*

The U.S. reserve position is denominated in SDR, as is the U.S. quota. Consequently, fluctuations in the value of the dollar with respect to the SDR results in valuation changes in dollar terms for the U.S. reserve position in the IMF as well as the IMF letter of credit. The Treasury Department periodically adjusts these balances to maintain the SDR value of the U.S. quota and records the change as a deferred gain or loss in its cumulative results of operations. These adjustments, known as maintenance of value adjustments, are settled annually after the close of the IMF financial year on April 30. Such adjustments do not involve a flow of funds. At April 30, 2008, the annual settlement with the IMF resulting from the depreciation of the dollar against the SDR since April 30, 2007, called for an upward adjustment of the U.S. quota by $3.4 billion and a corresponding decrease to Unexpended Appropriations on the Statement of Changes in Net Position (At April 30, 2007, the depreciation of the dollar against the SDR since April 30, 2006, called for an upward adjustment of the U.S. quota by $1.793 billion and a corresponding decrease to Unexpended Appropriations.) The dollar balances shown above for the U.S. quota include accrued valuation adjustments. At September 30, 2008, the

Treasury Department recorded a net deferred valuation loss in the amount of $15.5 million for deferred maintenance of value adjustments needed at year end ($258.2 million valuation gain at September 30, 2007).

The United States earns "remuneration" (interest) on its reserve position in the IMF except for the portion of the reserve position originally paid in gold. Remuneration is paid quarterly and is calculated on the basis of the SDR interest rate. The SDR interest rate is a market-based interest rate determined on the basis of a weighted average of interest rates on short-term instruments in the markets of the currencies included in the SDR valuation basket. Payment of a portion of this remuneration is deferred as part of a mechanism for creditors and debtors to share the financial consequences of overdue obligations to the IMF, such as unpaid overdue interest, and to similarly share the burden of establishing any contingency accounts deemed necessary to reflect the possibility of non-repayment of relevant principal amounts. As overdue interest is paid, previously deferred remuneration corresponding to the creditors' share of the burden of earlier nonpayment is included in the next payment of remuneration. The deferred remuneration corresponding to the creditors' share of establishing the contingency accounts is usually paid when there are no longer any relevant overdue obligations or when the IMF Executive Board determines to pay the remuneration. There was no deduction in the remuneration paid by the IMF as a result of burden-sharing during fiscal years 2008 or 2007. For fiscal years 2008 and 2007, the Treasury Department received $59 million and $107 million as remuneration (Note 5).

In addition to quota subscriptions, the IMF maintains borrowing arrangements to supplement its resources in times of crisis when IMF liquidity is low. The United States currently participates in two such arrangements – the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB). There were no U.S. loans outstanding under these arrangements in fiscal year 2008 and fiscal year 2007. The dollar equivalent of SDR $6.7 billion has been appropriated to finance U.S. participation in the GAB and NAB; as of September 30, 2008 and September 30, 2007, this amounted to $10.5 billion and $10.4 billion, respectively, in standing appropriations available for lending through the GAB or NAB as needed. As is the case for the U.S. quota in the IMF, budgetary treatment of U.S. participation in the GAB and NAB does not result in net budgetary outlays, since transactions under the GAB or NAB result in concurrent adjustments to the U.S. reserve position in the IMF.

9. INVESTMENTS IN INTERNATIONAL FINANCIAL INSTITUTIONS

The Treasury Department participates in Multilateral Development Banks (MDBs) to support poverty reduction, private sector development, and transition to market economies and sustainable economic growth and development, thereby advancing the United States' economic, political, and commercial interests abroad. The MDB consist of the World Bank Group (International Bank for Reconciliation and Development, International Finance Corporation, and Multilateral Investment Guarantee Agency), and five regional development banks (the African, Asian, European, Inter-American, and North American institutions), as enumerated in the table below. These investments are non-marketable equity investments valued at cost.

As of September 30, 2008 and September 30, 2007, investments in international financial institutions consisted of the following (in millions):

	2008	2007
African Development Bank	$ 172	$ 172
Asian Development Bank	458	458
European Bank for Reconstruction and Development	633	624
Inter-American Development Bank	1,482	1,480
International Bank for Reconstruction and Development	1,985	1,985
International Finance Corporation	569	569
Multilateral Investment Guarantee Agency	45	45
North American Development Bank	202	188
Total	**$ 5,546**	**$ 5,521**

Refer to Note 16 for a description of the contingent liability related to these institutions.

10. ACCOUNTS RECEIVABLE AND RELATED INTEREST

A. Tax, Other, and Related Interest Receivables, Net

Tax, other, and related interest receivables include receivables from tax assessments, excise taxes, fees, penalties, and interest assessed and accrued that were not paid or abated, reduced by an estimate for uncollectible amounts. In addition to amounts attributed to taxes, interest income due on monies deposited in Federal Reserve Banks is also included in this line item.

As of September 30, 2008 and September 30, 2007, Tax, Other, and Related Interest Receivables, and Net, consisted of the following (in millions):

Non-Entity:	2008	2007
IRS Federal Tax Receivable, Gross	$ 112,067	$ 98,016
Less: Allowance on Taxes Receivable	(83,046)	(72,007)
Receivable, Deposit of Earnings, Federal Reserve	1,465	1,291
Other Receivables and Interest	28	105
Less: Allowance on Other and Related Interest Receivable	(19)	(6)
Total Tax, and Other Non-Entity Receivables, Net	**$ 30,495**	**$ 27,399**
Entity:		
Miscellaneous Entity Receivables and Related Interest	383	160
Total Tax, Other and Related Interest Receivables, Net	**$ 30,878**	**$ 27,559**

IRS federal taxes receivable constitute the largest portion of the receivables. IRS federal taxes receivable consists of tax assessments, penalties, and interest which were not paid or abated, and which were agreed to by either the taxpayer and IRS, or the courts. An allowance for doubtful accounts is established for the difference between the gross receivables and the portion deemed collectible. The portion of tax receivables estimated to be collectible and the allowance for doubtful accounts are based on projections of collectability from a statistical sample of taxes receivable. The Treasury Department does not establish an allowance for the receivable on deposits of Federal Reserve earnings.

B. Intra-governmental Accounts and Related Interest Receivable

Intra-governmental accounts receivable and interest mainly represents non-entity payments made by the Treasury Department under the Contract Disputes Act ($368 million of the $396 million and $364 million of the $466 million displayed on the balance sheet for 2008 and 2007, respectively). Other federal agencies are required to reimburse the Treasury Department for payments made on their behalf, related to the Contract Disputes Act and the No Fear Act. These amounts are a receivable on the Treasury Department's books, of the Financial Management Service, and a payable on the other federal agencies' books until reimbursement is made. The remaining amount displayed as intra-governmental accounts receivable and interest is related to miscellaneous intra-governmental transactions.

11. INVENTORY AND RELATED PROPERTY, NET

Inventory and related property includes inventory, operating materials and supplies, and forfeited property held by Treasury. The Treasury Department's operating materials and supplies are maintained for the production of bureau products. The Treasury Department maintains inventory accounts or balances (e.g., metals, paper, etc.) for use in manufacturing currency and coins. The cost of these items is included in inventory costs, and is recorded as cost of goods sold upon delivery to customers. Inventory for check processing activities is also maintained. As of September 30, 2008 and September 30, 2007, inventory and related property consisted of the following (in millions):

	2008	2007
Operating materials and supplies held for use	$ 16	$ 15
Operating materials and supplies held in reserve for future use	24	23
Forfeited property	100	85
Inventory – raw materials	355	288
Inventory – work in process	86	117
Inventory – finished goods	135	121
Allowance for inventories and related property	(18)	(11)
Total Inventories and Related Property, Net	**$ 698**	**$ 638**

12. PROPERTY, PLANT, AND EQUIPMENT, NET

As of September 30, 2008 and September 30, 2007, property, plant, and equipment consisted of the following (in millions):

	Depreciation Method	Service Life	Cost	Accumulated Depreciation	2008 Net Book Value
Buildings, structures, and facilities	S/L	3 - 50 years	$ 669	$ (297)	$372
Furniture, fixtures, and equipment	S/L	2 - 20 years	3,376	(2,608)	768
Construction in progress	N/A	N/A	35	0	35
Land and land improvements	N/A	N/A	12	0	12
Internal use software	S/L	2 -10 years	1,151	(664)	487
Internal use software in development	N/A	N/A	205	0	205
Assets under capital lease	S/L	2 - 25 years	30	(20)	10
Leasehold improvements	S/L	2 - 25 years	580	(392)	188
Total			**$ 6,058**	**$ (3,981)**	**$ 2,077**

	Depreciation Method	Service Life	Cost	Accumulated Depreciation	2007 Net Book Value
Buildings, structures, and facilities	S/L	3 - 50 years	$ 658	$ (276)	$ 382
Furniture, fixtures, and equipment	S/L	2 - 20 years	3,271	(2,503)	768
Construction in progress	N/A	N/A	27	0	27
Land and land improvements	N/A	N/A	12	0	12
Internal use software	S/L	2-10 years	1,116	(564)	552
Internal use software in development	N/A	N/A	148	0	148
Assets under capital lease	S/L	2 - 25 years	25	(12)	13
Leasehold improvements	S/L	2 - 25 years	526	(342)	184
Total			**$ 5,783**	**$ (3,697)**	**$ 2,086**

The service life ranges vary significantly due to the diverse nature of PP&E held by the Treasury Department.

Heritage Assets

The Treasury Department Complex (Main Treasury Building and Annex) was declared a national historical landmark in 1972. The Treasury Department Complex is treated as a multi-use heritage asset and is expected to be preserved indefinitely.

13. NON-ENTITY ASSETS

As of September 30, 2008 and September 30, 2007, non-entity assets consisted of the following (in millions):

Intra-governmental Assets:	2008	2007
Fund Balance (Note 2)	$ 889	$ 874
Loans and Interest Receivable (Note 3)	226,194	202,488
Accounts Receivable and Related Interest (Note 10)	372	367
Advances to the Black Lung Trust Fund (Note 4)	10,484	10,058
Due from the General Fund (Note 4)	10,100,763	9,052,624
Total Non-Entity Intra-governmental Assets	**$ 10,338,702**	**$ 9,266,411**
Cash, Foreign Currency, and Other Monetary Assets (Note 5)	364,941	70,701
Gold and Silver Reserves (Note 6)	11,062	11,062
Loans and Interest Receivable (Note 3)	130	133
Investments in Government Sponsored Enterprises (Note 7)	7,032	0
Tax, Other, and Related Interest Receivable, Net (Note 10)	30,495	27,399
Miscellaneous Assets	12	9
Total Non-Entity Assets	**$ 10,752,374**	**$ 9,375,715**

Non-entity assets are those that are held by the Treasury Department but are not available for use by the Treasury Department. For example, Non-entity fund balance with Treasury represents unused balances of appropriations received by various Treasury Department entities to conduct custodial operations such as the payment of interest on the federal debt and refunds of taxes and fees. Non-entity loans and interest receivable represents loans managed by the Treasury Department on behalf of the U.S. Government. These loans are provided to federal agencies, and the Treasury Department is responsible for collecting these loans and transferring the proceeds to the General Fund of the U.S. Government. Non-entity cash, foreign currency, and other monetary assets include the operating cash of the U.S. Government, managed by the Treasury Department. It also includes foreign currency maintained by various U.S. and military disbursing offices, as well as seized monetary instruments.

On September 18, 2008, the Bureau of Public Debt began issuing specific cash management bills to fund the Supplementary Financing Program (SFP). The SFP is a temporary program that was announced by the Treasury Department and the Federal Reserve on September 17, 2008. The purpose of the program is to provide emergency cash for the Federal Reserve initiatives aimed at addressing the ongoing crisis in financial markets. The balance listed above of $364,941 million for 2008 is an increase over $70,701 million in 2007 as a result of the program. As of September 30, 2008, there were a total of eight cash management bills outstanding that totaled $300 billion (Notes 5, 14, 24, and 25).

14. FEDERAL DEBT AND INTEREST PAYABLE

The Treasury Department is responsible for administering the federal debt on behalf of the U.S. Government. The federal debt includes borrowings from the public as well as borrowings from federal agencies. The federal debt managed by the Treasury Department does not include debt issued by other governmental agencies such as the Tennessee Valley Authority or the Department of Housing and Urban Development.

The federal debt as of September 30, 2008 and September 30, 2007 was as follows (in millions):

	2008	2007
Intra-governmental		
Beginning Balance	$ 3,922,548	$ 3,628,701
New Borrowings/Repayments	257,022	293,847
Subtotal at Par Value	**4,179,570**	**3,922,548**
Premium/(Discount)	32,489	3,672
Interest Payable Covered by Budgetary Resources	50,355	48,568
Total	**$ 4,262,414**	**$ 3,974,788**

	2008	2007
Owed to the Public		
Beginning Balance	$ 5,049,305	$ 4,843,121
New Borrowings/Repayments	759,386	206,184
Subtotal at Par Value	**5,808,691**	**5,049,305**
Premium/(Discount)	(36,124)	(39,441)
Interest Payable Covered by Budgetary Resources	40,127	44,386
Total	**$ 5,812,694**	**$ 5,054,250**

Debt held by the public approximates the U.S. Government's competition with other sectors in the credit markets. In contrast, debt held by federal entities, primarily trust funds, represents the cumulative annual surpluses of these funds (*i.e.*, excess of receipts over disbursements plus accrued interest) that have been used to finance general government operations.

Federal Debt held by Other Federal Agencies

Certain federal agencies are allowed to invest excess funds in debt securities issued by the Treasury Department on behalf of the U.S. Government. The terms and the conditions of debt securities issued are designed to meet the cash needs of the U.S. Government. The vast majority is non-marketable securities issued at par value, but some are issued at market prices whose prices and interest rates reflect market terms. The average interest rate for debt held by the federal entities in fiscal year 2008 was 4.83percent (5.1percent in fiscal year 2007).

The federal debt also includes intra-governmental marketable debt securities that certain agencies are permitted to buy and sell on the open market. The debt, at par value (not including interest receivable), owed to federal agencies as of September 30, 2008 and September 30, 2007 was as follows (in millions):

	2008	2007
Social Security Administration	$ 2,367,138	$ 2,182,091
Office of Personnel Management	797,107	762,013
Department of Defense Agencies	335,672	288,456
Department of Health and Human Services	380,540	361,294
All Other Federal Entities - Consolidated	299,113	328,694
Total Federal Debt Held by Federal Entities	**$ 4,179,570**	**$ 3,922,548**

The above balances do not include premium/discount and interest payable.

Federal Debt Held by the Public

As of September 30, 2008 and September 30, 2007, Federal Debt held by the Public consisted of the following:

(at par value, in millions)	Term	Average Interest Rates	2008
Marketable:			
Treasury Bills	1 Year or Less	1.6%	$ 1,484,332
Treasury Notes	2 - 10 Years	4.1%	2,623,364
Treasury Bonds	Over 10 Years	7.1%	578,504
Treasury Inflation Protected Security (TIPS)	5 Years or More	2.0%	523,951
Total Marketable			**$ 5,210,151**
Non-Marketable	On Demand to Over 10 Years	4.1%	598,540
Total Federal Debt (Public)			**$ 5,808,691**

(at par value, in millions)	Term	Average Interest Rates	2007
Marketable:			
Treasury Bills	1 Year or Less	4.6%	$ 954,607
Treasury Notes	2 - 10 Yearss	4.4%	2,456,100
Treasury Bonds	Over 10 Years	7.4%	560,922
Treasury Inflation Protected Security (TIPS)	5 Years or More	2.3%	456,776
Total Marketable			**4,428,405**
Non-Marketable	On Demand to Over 10 Years	4.9%	620,900
Total Federal Debt (Public)			**$ 5,049,305**

The above balances do not include premium/discount and interest payable.

The Treasury Department issues marketable bills at a discount and pays the par amount of the security upon maturity. The average interest rate on Treasury bills represents the original issue effective yield on securities outstanding as of September 30, 2008 and 2007, respectively. Treasury bills are issued with a term of one year or less.

The Treasury Department issues marketable notes and bonds as long-term securities that pay semi-annual interest based on the securities' stated interest rates. These securities are issued at either par value or at an amount that reflects a discount or a premium. The average interest rate on marketable notes and bonds represents the stated interest rate adjusted by any discount or premium on securities outstanding as of September 30, 2008 and 2007. Treasury notes are issued with a term of 2 to 10 years and Treasury bonds are issued with a term of more than 10 years. The Treasury Department also issues inflation–indexed securities (TIPS) that have interest and redemption payments, which are tied to the Consumer Price Index, a widely used measurement of inflation. TIPS are issued with a term of five years or more. At maturity, TIPS are redeemed at the inflation-adjusted principal amount, or the original par value, whichever is greater. TIPS pay a semi-annual fixed rate of interest applied to the inflation-adjusted principal.

Over the course of fiscal year 2008, changes in economic conditions, financial markets, and fiscal policy as well as a reduction in nonmarketable debt issuance have caused an increase in Treasury's marketable borrowing needs. Financial market strains have impacted the real economy, and the nation has experienced lower economic growth, lower receipts, and increased outlays. Treasury has responded to the increase in marketable borrowing requirements by increasing issuance sizes of regular bills, the frequency, terms, and issuance sizes of cash management bills, and the issuance sizes of nominal coupon security offerings.

Federal Debt Held by the Public includes federal debt held outside of the U. S. Government by individuals, corporations, Federal Reserve Banks (FRB), state and local governments, and foreign governments and central banks. As of September 30, 2008, the FRB owned $221 billion, net of $256 billion in securities lent to dealers, for total holdings of $477 billion. As of September 30, 2007, the FRB owned $775 billion, net of $5 billion in securities lent to dealers, for total holdings of $780 billion. These securities are held in the FRB System Open Market Account (SOMA) for the purpose of conducting monetary policy.

Other Debt and Interest Payable

Borrowings outstanding are with the Civil Service Trust Fund, which is administered by the Office of Personnel Management. The interest rates on these borrowings range from 4.62 percent to 5.62 percent, and the maturity dates range from June 30, 2009 to June 30, 2019. Borrowings began in 2005.

15. D.C. PENSIONS AND JUDICIARY RETIREMENT ACTUARIAL LIABILITY

Pursuant to Title XI of the Balanced Budget Act of 1997, as amended (the Act), on October 1, 1997, Treasury became responsible for certain District of Columbia retirement plans. The Act was intended to relieve the District of Columbia government of the burden of unfunded pension liabilities transferred to the District by the U.S. Government in 1979. To fulfill its responsibility, Treasury manages two funds — the D.C. Teachers, Police Officers, and Firefighters Federal Pension Fund (the D.C. Federal Pension Fund), and the District of Columbia Judicial Retirement and Survivors Annuity Fund (the Judicial Retirement Fund). The Treasury Department is required to make annual amortized payments from the General Fund of the U.S. Government to the D.C. Federal Pension Fund and the Judicial Retirement Fund. The actuarial cost method used to determine costs for the retirement plans is the Aggregate Entry Age Normal Actuarial Cost Method. The actuarial liability is based upon long-term assumptions selected by the Treasury Department. The pension benefit costs incurred by the plans are included on the Consolidated Statements of Net Cost.

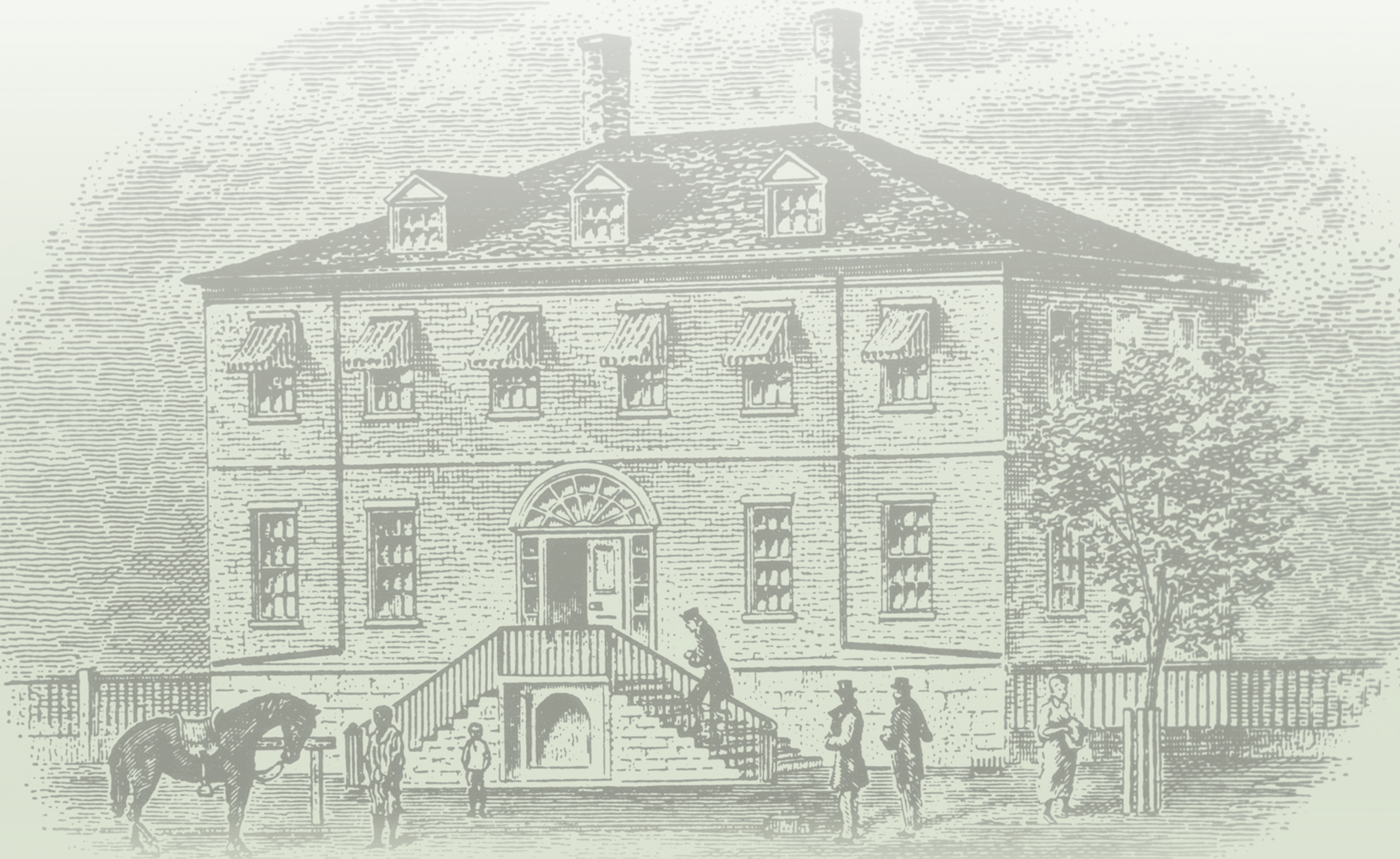
D.C. Federal Pension Fund

The purpose of the D.C. Federal Pension Fund is to make federal benefit payments and pay necessary administrative expenses for the District of Columbia Police Officers', Firefighters', and Teachers' Retirement Plans for benefits earned based upon service on or before June 30, 1997. The amount paid into the D.C. Federal Pension Fund from the General Fund of the U.S. Government was $340.2 million for fiscal year 2008 ($345.4 million during fiscal year 2007). As of September 30, 2008, the unobligated budgetary resources of the D.C. Federal Pension Fund were approximately $3,564 million, and the pension actuarial liability was $8,641 million, resulting in an unfunded liability of $5,077 million. (As of September 30, 2007, the unobligated budgetary resources of the D.C. Federal Pension Fund were approximately $3,565 million, and the pension actuarial liability was $8,842 million, resulting in an unfunded liability of $5,277 million.) In fiscal year 2008, the assumption for the annual rate of investment return in fiscal year 2009 is 4.7percent for the D.C. Federal Pension Fund with a gradual increase to 6.0percent by fiscal year 2014; and the assumption for the future annual rate of inflation and future cost-of-living adjustments is 3.5percent. In fiscal year 2007, the assumption for the annual rate of investment return for the D.C. Federal Pension Fund in fiscal year 2008 was 4.7percent with a gradual increase to 6percent by fiscal year 2013; and the assumption for the future annual rate of inflation and future cost-of-living adjustments was 3.5percent. In fiscal year 2008, the assumption for the future annual rate of salary increases is 6.5percent for police officers and firefighters (also 6.5percent during fiscal year 2007), and 5.5percent for teachers (also 5.5percent during fiscal year 2007).

Judicial Retirement Fund

The purpose of the Judicial Retirement Fund is to make federal benefit payments and pay necessary administrative expenses for the Judges' Retirement Plans for all benefits earned. The amount paid into the Judicial Retirement Fund from the General Fund of the U.S. Government will be $6.98 million for fiscal year 2008 ($7.4 million during fiscal year 2007). As of September 30, 2008, the unobligated budgetary resources of the Judicial Retirement Fund were approximately $118.5 million, and the pension actuarial liability was $161.6 million, resulting in an unfunded liability of $43.1 million. (as of September 30, 2007, the unobligated budgetary resources of the Judicial Retirement Fund were approximately $114.3 million, and the pension actuarial liability was $150.1 million, resulting in an unfunded liability of $35.8 million.) In fiscal year 2008, the assumption for the annual rate of investment return for the Judicial Retirement Fund in fiscal year 2009 is 5.2percent for the Judicial Retirement Fund with a gradual increase

to 6.0percent by fiscal year 2015; and the assumption for the future annual rate of inflation and future cost-of-living adjustments is 3.5percent. In fiscal year 2007, the assumption for the future annual rate of investment return for the Judicial Retirement Fund was 6percent; and the assumption for the future annual rate of inflation and future cost-of-living adjustments was 3.5percent. In fiscal year 2008, the assumption for the future annual rate of salary increases is 3.5percent for judges. This assumption is unchanged from fiscal year 2007.



16. COMMITMENTS AND CONTINGENCIES

Legal Contingencies

The Department is a party in various administrative proceedings, legal actions, and claims including equal opportunity matters which may ultimately result in settlements or decisions adverse to the Federal Government. These contingent liabilities arise in the normal course of operations and their ultimate disposition is unknown. Treasury has one contingent liability in fiscal year 2008 related to the legal action taken on the case, American Council of the Blind and Others, where losses are determined to be probable and amounts can be estimated. The Department has disclosed contingent liabilities where the conditions for liability recognition have not been met and the likelihood of unfavorable outcome is more than remote. The Department does not accrue for possible losses related to cases where the potential loss cannot be estimated or the likelihood of an unfavorable outcome is less than probable.

In some cases, a portion of any loss that may occur may be paid by the Treasury's Judgment Fund which is separate from the operating resources of the Department. For those cases related to awards under federal anti-discrimination and whistleblower protection acts, Treasury must reimburse the Judgment Fund from future appropriations.

In the opinion of the Department's management and legal counsel, based on information currently available, the expected outcome of legal actions, individually or in the aggregate, will not have a materially adverse effect on the Department's financial statements, except for the legal actions described below.

Pending Legal Actions

- ***The American Council of the Blind and Others:*** Plaintiffs have filed suit against the Department under Section 504 of the Rehabilitation Act seeking the redesign of U.S. currency. In 2006, a judge ruled that the current U.S. currency design violates this Act and this ruling was appealed. In 2008, the United States Court of Appeals for the District of Columbia Circuit affirmed this ruling. No monetary damages were awarded by the Court. However, the Department is required to provide meaningful access to United States currency for blind and other visually impaired persons. This may require changes to U.S. currency (excluding the one-dollar note.) The Court ordered such changes shall be completed, in connection with each denomination of currency, not later than the date when a redesign is next approved by the Secretary of the Treasury. Because the cost of these changes will be incorporated into future currency redesign costs, no redesign costs have been accrued in the accompanying financial statements as of September 30, 2008 and 2007.

  The judge in the above mentioned case also has ordered that the parties confer and attempt to negotiate attorney fees and costs to be awarded the plaintiffs. A preliminary attorney fee and cost estimate of $800,000 is included in other accrued liabilities. However, updated information has changed this figure to a range of $900,000 to $1,200,000.

- ***Amidax Trading Group v. S.W.I.F.T.:*** Allegations have been made that S.W.I.F.T. unlawfully disclosed information to the U.S. Government. We have no opinion as to the likelihood of an unfavorable outcome or an estimate of potential loss at this time.

- ***Cobell et al. v. Kempthorne et al. (formerly Cobell v. Norton):*** Native Americans allege that the Department of Interior and the Treasury Department have breached trust obligations with respect to the management of the plaintiffs' individual Indian monies. On August 7, 2008, a Federal District Court issued

an opinion awarding $455 million to the plaintiffs. The opinion is not a final order, and both parties have petitioned for the right to appeal. The Department of the Interior is also a defendant in this case and will be reporting this case in their financial statements.

- ***Tribal Trust Fund Cases:*** Numerous cases have been filed in which Native American Tribes seek a declaration that the U.S. has not provided the tribes with a full and complete accounting of their trust funds, and seek an order requiring the government to provide such an accounting. In addition, there are a number of other related cases for damages which do not name the Treasury Department as a defendant. It is not possible at this time to determine the likelihood of an unfavorable outcome or an estimate of the amount or range of any potential loss. The Department of the Interior is also a defendant in these cases.

- ***Other Legal Actions:*** The Department is also involved in employment related legal actions (*e.g.*, Discrimination, Equal Employment Opportunity Commission, Merit System Protection Board, etc.) which were reported to have a "reasonably possible" chance of being decided in the plaintiff's favor. However, an estimate of potential loss cannot be determined at this time. It is not expected that these cases will have a material effect on Treasury's financial position or results.

There are also other legal actions pending where the ultimate resolution of the legal actions, for which the possibility of loss could not be determined, may materially affect Treasury's financial position or results. As of September 30, 2008, three legal claims amounting to approximately $156.5 million existed for which the possibility of loss could not be determined.

Other Contingencies

Multilateral Development Banks (MDB): The Treasury Department has subscribed to capital for certain MDB, portions of which are callable under certain limited circumstances to meet the obligations of the respective MDB. There has never been, nor is there anticipated, a call on the Treasury Department subscriptions. As of September 30, 2008 and September 30, 2007, U.S. callable capital in MDB was as follows (in millions):

	2008	2007
African Development Bank	$ 1,634	$ 1,602
Asian Development Bank	5,911	5,911
European Bank for Reconstruction and Development	1,805	1,805
Inter-American Development Bank	28,687	28,687
International Bank for Reconstruction and Development	22,641	22,641
Multilateral Investment Guarantee Agency	301	301
North American Development Bank	1,275	1,275
Total	**$ 62,254**	**$ 62,222**

Terrorism Risk Insurance Program: The Terrorism Risk Insurance Act (TRIA or the Act) was signed into law on November 26, 2002. This law was enacted to address market disruptions resulting from terrorist attacks on September 11, 2001. The Act helps to ensure available and affordable commercial property and casualty insurance for terrorism risk, and simultaneously allows private markets to stabilize. The Terrorism Risk Insurance Program is activated upon the certification of an "act of terrorism" by the Secretary of the Treasury in concurrence with the Secretary of State and the Attorney General. If a certified act of terrorism occurs, insurers may be eligible to receive

reimbursement from the Federal Government for insured losses above a designated deductible amount. Insured losses above this amount will be shared between insurance companies and the Federal Government. The Act also gives Treasury authority to recoup federal payments made under the Program through policyholder surcharges under certain circumstances and contains provisions designed to manage litigation arising from or relating to a certified act of terrorism.

The original TRIA program was to expire on December 31, 2005, but the Program was extended through December 31, 2007, by the Terrorism Risk Insurance Extension Act of 2005 (Extension Act). This law included the following significant changes: it reduced the Federal role in terrorism risk insurance markets by increasing insurer deductibles and excluding certain types of previously covered insurance. The Extension Act also reduced the Federal Government's share of insured losses and added a "Program Trigger" provision which precludes federal payments unless insured losses from a certified act of terrorism exceeds $100 million.

On December 26, 2007, the President signed into law the Terrorism Risk Insurance Program Reauthorization Act of 2007 (Reauthorization Act) extending the Program through December 31, 2014. The Reauthorization Act, among other Program changes, revised the definition of "Act of Terrorism" to remove the certification requirement that the act be committed by an individual acting on behalf of a foreign person or foreign interest; revised the provisions of the Act with regard to the cap on annual liability for insured losses of $100 billion; and established deadlines by which recoupment of federal payments made under the Program would have to be accomplished.

17. LIABILITIES

Liabilities Not Covered by Budgetary and Other Resources

As of September 30, 2008 and September 30, 2007, liabilities not covered by budgetary and other resources consisted of the following (in millions):

	2008	2007
Intra-governmental Liabilities Not Covered by Budgetary and Other Resources:		
Federal Debt Principal, Premium/Discount (Note 14)	$ 4,212,059	$ 3,926,220
Other Intra-governmental Liabilities	105	105
Total Intra-governmental Liabilities Not Covered by Budgetary and Other Resources	**$ 4,212,164**	**$ 3,926,325**
Federal Debt Principal, Premium/Discount (Note 14)	5,772,567	5,009,864
D.C. Pensions Liability (Note 15)	5,120	5,313
Other Liabilities	1,085	1,037
Total Liabilities Not Covered by Budgetary and Other Resources	**$ 9,990,936**	**$ 8,942,539**

Other Liabilities

Total "Other Liabilities" displayed on the Balance Sheets consists of both liabilities that are covered and not covered by budgetary resources.

The amounts displayed of $17,852 million and $3,664 million, respectively, at September 30, 2008 and September 30, 2007, consisted of the following (in millions):

	2008		
	Current	Non-Current	Total
Intra-governmental			
Unfunded Federal Workers Compensation Program Liability (FECA)	$ 45	$ 57	$ 102
Accounts Payable	76	0	76
Other Accrued Liabilities	165	2	167
Total Intra-governmental	**$ 286**	**$ 59**	**$ 345**
With the Public			
GSE Quarter Ended 9/30/08 Keepwell Payable (Note 24)	$ 13,800	$ 0	$ 13,800
Actuarial Federal Workers Compensation Program Liability (FECA)	0	594	594
Liability for Deposit Funds (Held by the Federal Government for Others) and Suspense Accounts	526	0	526
Accrued Funded Payroll and Benefits	424	0	424
Capital Lease Liabilities	4	1	5
Accounts Payable and Other Accrued Liabilities	2,460	43	2,503
Total with the Public	**$ 17,214**	**$ 638**	**$ 17,852**

	2007		
	Current	Non-Current	Total
Intra-governmental			
Unfunded Federal Workers Compensation Program Liability (FECA)	$ 44	$ 58	$ 102
Accounts Payable	46	21	67
Other Accrued Liabilities	158	2	160
Total Intra-governmental	**$ 248**	**$ 81**	**$ 329**
With the Public			
Actuarial Federal Workers Compensation Program Liability (FECA)	$ 0	$ 573	$ 573
Liability for Deposit Funds (Held by the Federal Government for Others) and Suspense Accounts	573	0	573
Accrued Funded Payroll and Benefits	402	0	402
Capital Lease Liabilities	2	5	7
Accounts Payable and Other Accrued Liabilities	2,045	64	2,109
Total with the Public	**$ 3,022**	**$ 642**	**$ 3,664**

18. NET POSITION

Unexpended Appropriations represents the amount of spending authorized as of year-end that is unliquidated or unobligated and has not lapsed, been rescinded, or withdrawn. No-year appropriations remain available for obligation until expended. Annual appropriations remain available for upward or downward adjustment of obligations until expired.

Cumulative Results of Operations represents the net results of operations since inception, and includes cumulative amounts related to investments in capitalized assets and donations and transfers of assets in and out without reimbursement. Also included as a reduction in Cumulative Results of Operations are accruals for which the related expenses require funding from future appropriations and assessments. These future funding requirements include, among others (a) accumulated annual leave earned but not taken, (b) accrued workers compensation, and (c) expenses for contingent liabilities.

The amount reported as "appropriations received" are appropriated from Treasury General Fund of the U.S. Government receipts, such as income taxes, that are not earmarked by law for a specific purpose. This amount will not necessarily agree with the "appropriation received" amount reported on the Statement of Budgetary Resources (SBR) because of differences between proprietary and budgetary accounting concepts and reporting requirements. For example, certain dedicated and earmarked receipts are recorded as "appropriations received" on the SBR, but are recognized as exchange or non-exchange revenue (*i.e.*, typically in special and non-revolving trust funds) and reported on the Statement of Changes in Net Position in accordance with Statement of Federal Financial Accounting Standards (SFFAS No. 7).

Transfers to the General Fund and Other

The amount reported as "Transfers to the General Fund and Other" on the Consolidated Statements of Changes in Net Position under "Other Financing Sources" mainly represents the distribution of interest revenue to the General Fund of the U.S. Government of $13.5 billion and $12.4 billion, for the year ended September 30, 2008 and year ended September 30, 2007, respectively and $7.032 billion for the value of the GSE stock transactions for the year ended September 30, 2008. The interest revenue is accrued on inter-agency loans held by the Treasury Department on behalf of the U.S. Government. A corresponding balance is reported on the Consolidated Statement of Net Cost under "Federal Costs: Less Interest Revenue from Loans." The amount reported on the Consolidated Statement of Net Cost is reduced by eliminations with Treasury Department bureaus.

The Treasury Department also includes seigniorage in "Transfers to the General Fund and Other." Seigniorage is the face value of newly minted circulating coins less the cost of production. The United States Mint is required to distribute the seigniorage that it recognizes to the General Fund of the U.S. Government. The distribution is also included in "Transfers to the General Fund and Other." In any given year, the amount recognized as seigniorage may differ for the amount distributed to the General Fund by an insignificant amount due to timing differences.

Seigniorage in the amounts of $728.6 million and $1,032 million was recognized, respectively, for the year ended September 30, 2008 and year ended September 30, 2007. Distributions to the General Fund, including seigniorage, and numismatic profit amounted to $750 million and $825 million, respectively, for the years ended September 30, 2008 and September 30, 2007.

19. CONSOLIDATED STATEMENT OF NET COST AND NET COSTS OF TREASURY SUB-ORGANIZATIONS

The Treasury Department's Consolidated Statement of Net Cost displays information on a consolidated basis. The complexity of the Treasury Department's organizational structure and operations requires that supporting schedules for Net Cost be included in the notes to the financial statements. These supporting schedules provide consolidating information, which fully displays the costs of each sub-organization (Departmental Offices and each operating bureau).

The classification of sub-organizations has been determined in accordance with SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* which states that the predominant factor is the reporting entity's organization structure and existing responsibility components, such as bureaus, administrations, offices, and divisions within a department.

Each sub-organization is responsible for accumulating costs. The assignment of the costs to Treasury-wide programs is the result of using the following cost assignment methods: (1) direct costs, (2) cause and effect, and (3) cost allocation.

Intra-Departmental costs/revenues resulting from the provision of goods and/or services on a reimbursable basis among Departmental sub-organizations are reported as costs by providing sub-organizations. Accordingly, such costs/revenues are eliminated in the consolidation process.

To the extent practical or reasonable to do so, earned revenue is deducted from the gross costs of the programs to determine their net cost. There are no precise guidelines to determine the degree to which earned revenue can reasonably be attributed to programs. The attribution of earned revenues requires the exercise of managerial judgment.

In fiscal year 2008, the management of the Treasury Franchise Fund (BPF) was transferred from the Departmental Offices (DO) to the Bureau of the Public Debt (BPD). Accordingly, BPF is included with BPD for fiscal year 2008 reporting. For comparative purposes, this resulted in an increase in amounts reported under the Management Program for BPD in fiscal year 2008 and a decrease in the amounts reported for DO.

In fiscal year 2008, BPD began consolidating BPF. It should be noted that the 2008 Consolidated Statement of Net Cost by Treasury Sub-organization DO includes BPF, in fiscal year 2007 statement it is included in BPD. This change has an immaterial effect on the statement.

In fiscal year 2008, the Treasury Department began incurring costs in association with the intervention programs with GSEs. The amount reflected in the Statement of Net Cost for 2008 is $13,800 million. This is the expense portion of the quarter ended September 30, 2008 Keepwell payment to ensure liquidity of Freddie Mac. There was no payment anticipated or accrued for Fannie Mae.

The Treasury Department's Consolidated Statement of Net Cost also presents interest expense on the Federal Debt and other federal costs incurred as a result of assets and liabilities managed on behalf of the U.S. Government. These costs are not reflected as program costs related to the Treasury Department's strategic plan missions. Such costs are eliminated in the consolidation process to the extent that they involve transactions with Treasury Department sub-organizations.

OMB Circular No. A-136, *Financial Reporting Requirements,* requires that the presentation of the Statements of Net Cost align directly with the goals and outcomes identified in the Strategic Plan. Accordingly, the Treasury Department has presented the gross costs and earned revenues by the applicable mission goals in the Treasury Department's fiscal years 2007–2012 Strategic Plan.

Other federal costs for the years ended September 30, 2008 and September 30, 2007 consisted of the following (in millions):

	2008	2007
Credit Reform Interest on Uninvested Funds (Intra-governmental)	$ 5,043	$ 4,632
Resolution Funding Corporation	1,393	1,987
Judgment Claims and Contract Disputes	786	1,222
Corporation for Public Broadcasting	448	464
Legal Services Corporation	347	350
All Other Payments	315	208
Total	**$ 8,332**	**$ 8,863**

19. Consolidated Statement of Net Cost and Net Costs of Treasury Sub-organizations (In Millions):

Fiscal Year Ended September 30, 2008 Program Costs:	Bureau of Engraving and Printing	Bureau of the Public Debt	Departmental Offices	Financial Crimes Enforcement Network	Financial Management Service	Internal Revenue Service	U.S. Mint
FINANCIAL PROGRAM:							
Intra-governmental Gross Costs	$ 0	$ 71	$ 1,392	$ 0	$ 202	$ 4,107	$ 0
Less: Earned Revenue	0	(15)	(2,009)	0	(159)	(72)	0
Intra-governmental Net Costs	0	56	(617)	0	43	4,035	0
Gross Costs with the public	0	256	373	0	1,120	8,441	0
Less: Earned Revenue	0	(10)	(1)	0	0	(287)	0
Net Costs with the public	0	246	372	0	1,120	8,154	0
Net Cost: Financial Program	**0**	**302**	**(245)**	**0**	**1,163**	**12,189**	**0**
ECONOMIC PROGRAM:							
Intra-governmental Gross Costs	81	0	462	0	0	0	78
Less: Earned Revenue	(8)	0	(811)	0	0	0	(10)
Intra-governmental Net Costs	73	0	(349)	0	0	0	68
Gross Costs with the public	449	0	1,740	0	0	0	1,958
Less: Earned Revenue	(509)	0	(1,529)	0	0	0	(2,063)
Net Costs with the public	(60)	0	211	0	0	0	(105)
Net Cost: Economic Program	**13**	**0**	**(138)**	**0**	**0**	**0**	**(37)**
SECURITY PROGRAM:							
Intra-governmental Gross Costs	0	0	139	58	0	0	0
Less: Earned Revenue	0	0	(18)	(2)	0	0	0
Intra-governmental Net Costs	0	0	121	56	0	0	0
Gross Costs with the public	0	0	171	52	0	0	0
Less: Earned Revenue	0	0	0	0	0	0	0
Net Costs with the public	0	0	171	52	0	0	0
Net Cost: Security Program	**0**	**0**	**292**	**108**	**0**	**0**	**0**
MANAGEMENT PROGRAM:							
Intra-governmental Gross Costs	0	51	143	0	0	0	0
Less: Earned Revenue	0	(237)	(224)	0	0	0	0
Intra-governmental Net Costs	0	(186)	(81)	0	0	0	0
Gross Costs with the public	0	207	300	0	0	0	0
Less: Earned Revenue	0	0	0	0	0	0	0
Net Costs with the public	0	207	300	0	0	0	0
Net Cost: Management Program	**0**	**21**	**219**	**0**	**0**	**0**	**0**
Net Cost of Treasury Operations	**$ 13**	**$ 323**	**$ 128**	**$ 108**	**$ 1,163**	**$ 12,189**	**$ (37)**

Fiscal Year Ended September 30, 2008 — Program Costs:	Office of the Comptroller of the Currency	Office of Thrift Supervision	Alcohol, Tobacco Tax and Trade Bureau	Combined Total	Eliminations and Adjustments	9/30/2008 Consolidated
FINANCIAL PROGRAM:						
Intra-governmental Gross Costs	$ 0	$ 0	$ 13	$ 5,785	$ (1,442)	$ 4,343
Less: Earned Revenue	0	0	0	(2,255)	272	(1,983)
Intra-governmental Net Costs	0	0	13	3,530	(1,170)	2,360
Gross Costs with the public	0	0	36	10,226	0	10,226
Less: Earned Revenue	0	0	(1)	(299)	0	(299)
Net Costs with the public	0	0	35	9,927	0	9,927
Net Cost: Financial Program	**0**	**0**	**48**	**13,457**	**(1,170)**	**12,287**
ECONOMIC PROGRAM:						
Intra-governmental Gross Costs	96	34	13	764	(409)	355
Less: Earned Revenue	(27)	(14)	0	(870)	845	(25)
Intra-governmental Net Costs	69	20	13	(106)	436	330
Gross Costs with the public	584	217	36	4,984	0	4,984
Less: Earned Revenue	(710)	(254)	(1)	(5,066)	0	(5,066)
Net Costs with the public	(126)	(37)	35	(82)	0	(82)
Net Cost: Economic Program	**(57)**	**(17)**	**48**	**(188)**	**436**	**248**
SECURITY PROGRAM:						
Intra-governmental Gross Costs	0	0	0	197	(74)	123
Less: Earned Revenue	0	0	0	(20)	16	(4)
Intra-governmental Net Costs	0	0	0	177	(58)	119
Gross Costs with the public	0	0	0	223	0	223
Less: Earned Revenue	0	0	0	0	0	0
Net Costs with the public	0	0	0	223	0	223
Net Cost: Security Program	**0**	**0**	**0**	**400**	**(58)**	**342**
MANAGEMENT PROGRAM:						
Intra-governmental Gross Costs	0	0	0	194	(70)	124
Less: Earned Revenue	0	0	0	(461)	296	(165)
Intra-governmental Net Costs	0	0	0	(267)	226	(41)
Gross Costs with the public	0	0	0	507	0	507
Less: Earned Revenue	0	0	0	0	0	0
Net Costs with the public	0	0	0	507	0	507
Net Cost: Management Program	**0**	**0**	**0**	**240**	**226**	**466**
Net Cost of Treasury Operations	**$ (57)**	**$ (17)**	**$ 96**	**$ 13,909**	**$ (566)**	**$ 13,343**

19. Consolidated Statement of Net Cost and Net Costs of Treasury Sub-organizations (In Millions):

Fiscal Year Ended September 30, 2007 Program Costs:	Bureau of Engraving and Printing	Bureau of the Public Debt	Departmental Offices	Financial Crimes Enforcement Network	Financial Management Service	Internal Revenue Service	U.S. Mint
FINANCIAL PROGRAM:							
Intra-governmental Gross Costs	$ 0	$ 76	$ 1,395	$ 0	$ 171	$ 3,967	$ 0
Less: Earned Revenue	0	(14)	(2,097)	0	(144)	(45)	0
Intra-governmental Net Costs	0	62	(702)	0	27	3,922	0
Gross Costs with the public	0	259	474	0	981	8,049	0
Less: Earned Revenue	0	(3)	0	0	0	(231)	0
Net Costs with the public	0	256	474	0	981	7,818	0
Net Cost: Financial Program	**0**	**318**	**(228)**	**0**	**1,008**	**11,740**	**0**
ECONOMIC PROGRAM:							
Intra-governmental Gross Costs	81	0	69	0	0	0	69
Less: Earned Revenue	(5)	0	(850)	0	0	0	(9)
Intra-governmental Net Costs	76	0	(781)	0	0	0	60
Gross Costs with the public	466	0	2,593	0	0	0	1,520
Less: Earned Revenue	(573)	0	(3,033)	0	0	0	(1,595)
Net Costs with the public	(107)	0	(440)	0	0	0	(75)
Net Cost: Economic Program	**(31)**	**0**	**(1,221)**	**0**	**0**	**0**	**(15)**
SECURITY PROGRAM:							
Intra-governmental Gross Costs	0	0	135	51	0	0	0
Less: Earned Revenue	0	0	(13)	(1)	0	0	0
Intra-governmental Net Costs	0	0	122	50	0	0	0
Gross Costs with the public	0	0	126	57	0	0	0
Less: Earned Revenue	0	0	0	0	0	0	0
Net Costs with the public	0	0	126	57	0	0	0
Net Cost: Security Program	**0**	**0**	**248**	**107**	**0**	**0**	**0**
MANAGEMENT PROGRAM:							
Intra-governmental Gross Costs	0	0	167	0	0	0	0
Less: Earned Revenue	0	0	(720)	0	0	0	0
Intra-governmental Net Costs	0	0	(553)	0	0	0	0
Gross Costs with the public	0	0	770	0	0	0	0
Less: Earned Revenue	0	0	0	0	0	0	0
Net Costs with the public	0	0	770	0	0	0	0
Net Cost: Management Program	**0**	**0**	**217**	**0**	**0**	**0**	**0**
Net Cost of Treasury Operations	**$ (31)**	**$ 318**	**$ (984)**	**$ 107**	**$ 1,008**	**$ 11,740**	**$ (15)**

Fiscal Year Ended September 30, 2007 Program Costs:	Office of the Comptroller of the Currency	Office of Thrift Supervision	Alcohol, Tobacco Tax and Trade Bureau	Combined Total	Eliminations and Adjustments	9/30/2007 Consolidated
FINANCIAL PROGRAM:						
Intra-governmental Gross Costs	$ 0	$ 0	$ 14	$ 5,623	$ (1,441)	$ 4,182
Less: Earned Revenue	0	0	0	(2,300)	291	(2,009)
Intra-governmental Net Costs	0	0	14	3,323	(1,150)	2,173
Gross Costs with the public	0	0	35	9,798	0	9,798
Less: Earned Revenue	0	0	(2)	(236)	0	(236)
Net Costs with the public	0	0	33	9,562	0	9,562
Net Cost: Financial Program	**0**	**0**	**47**	**12,885**	**(1,150)**	**11,735**
ECONOMIC PROGRAM:						
Intra-governmental Gross Costs	89	30	13	351	(48)	303
Less: Earned Revenue	(27)	(16)	0	(907)	889	(18)
Intra-governmental Net Costs	62	14	13	(556)	841	285
Gross Costs with the public	548	195	35	5,357	0	5,357
Less: Earned Revenue	(669)	(227)	(1)	(6,098)	0	(6,098)
Net Costs with the public	(121)	(32)	34	(741)	0	(741)
Net Cost: Economic Program	**(59)**	**(18)**	**47**	**(1,297)**	**841**	**(456)**
SECURITY PROGRAM:						
Intra-governmental Gross Costs	0	0	0	186	(67)	119
Less: Earned Revenue	0	0	0	(14)	12	(2)
Intra-governmental Net Costs	0	0	0	172	(55)	117
Gross Costs with the public	0	0	0	183	0	183
Less: Earned Revenue	0	0	0	0	0	0
Net Costs with the public	0	0	0	183	0	183
Net Cost: Security Program	**0**	**0**	**0**	**355**	**(55)**	**300**
MANAGEMENT PROGRAM:						
Intra-governmental Gross Costs	0	0	0	167	(54)	113
Less: Earned Revenue	0	0	0	(720)	277	(443)
Intra-governmental Net Costs	0	0	0	(553)	223	(330)
Gross Costs with the public	0	0	0	770	0	770
Less: Earned Revenue	0	0	0	0	0	0
Net Costs with the public	0	0	0	770	0	770
Net Cost: Management Program	**0**	**0**	**0**	**217**	**223**	**440**
Net Cost of Treasury Operations	**$ (59)**	**$ (18)**	**$ 94**	**$ 12,160**	**$ (141)**	**$ 12,019**

20. ADDITIONAL INFORMATION RELATED TO THE COMBINED STATEMENTS OF BUDGETARY RESOURCES

Federal agencies are required to disclose additional information related to the Combined Statements of Budgetary Resources (per OMB Circular A-136, *Financial Reporting Requirements as amended*). In accordance with SFFAS No. 7, the Department must report the value of goods and services ordered and obligated which have not been received. This amount includes any orders for which advance payment has been made but for which delivery or performance has not yet occurred. The information for the fiscal years ended September 30, 2008 and September 30, 2007 was as follows (in millions):

	2008	2007
Undelivered orders at the end of the period	$ 57,513	$ 56,304
Available borrowing and contract authority at the end of the period	$ 5,716	$ 5,716

Apportionment Categories of Obligations Incurred: Direct vs. Reimbursable Obligations

	2008	2007
Obligations Incurred		
Direct - Category A	$ 7,050	$ 6,525
Direct - Category B	20,623	14,197
Direct - Exempt from Apportionment	455,126	440,277
Total Direct	**$ 482,799**	**$ 460,999**
Reimbursable - Category A	2	0
Reimbursable - Category B	3,287	3,344
Reimbursable - Exempt from Apportionment	1,446	1,187
Total Reimbursable	$ 4,735	$ 4,531
Total Direct and Reimbursable	**$ 487,534**	**$ 465,530**

Reconciliation of the President's Budget

The *Budget of the United States* (also known as the President's Budget), with actual numbers for fiscal year 2008, was not published at the time that these financial statements were issued. The President's Budget is expected to be published in 2009. It will be available from the United States Government Printing Office. The following chart displays the differences between the Combined Statement of Budgetary Resources (SBR) in the fiscal year 2007 Performance and Accountability Report and the actual fiscal year 2007 balances included in the fiscal year 2009 President's Budget (PB).

Reconciliation of Fiscal Year 2007 Combined Statement of Budgetary Resources to the Fiscal Year 2009 President's Budget (in Millions)

	Budgetary Resources	Outlays (net of offsetting collections)	Offsetting Receipts	Net Outlays	Obligations Incurred
Statement of Budgetary Resources Amounts	**$ 522,980**	**$ 452,110**	**$ (16,040)**	**$ 436,070**	**$ 465,530**
Included in the Treasury Chapter of the President's Budget (PB) but not in the Statement of Budgetary Resources (SBR):					
IRS non-entity tax credit payments (1)	57,830	57,830	(13)	57,817	57,830
Tax and Trade Bureau (TTB) non-entity collections for Puerto Rico	462	462	0	462	0
Non-Treasury offsetting receipts included in Treasury chapter of PB	0	0	(53)	(53)	0
Treasury offsetting receipts considered to be "General Fund" transactions for reporting purposes (2)	0	0	(53)	(53)	0
Continued dumping subsidy – CBP	388	381	0	381	381
Other	2	1	(1)	0	1
Subtotal	**$ 58,682**	**$ 58,674**	**$ (120)**	**$ 58,554**	**$ 58,212**
Included in the SBR but not in the Treasury chapter of the PB:					
Treasury resources shown in non-Treasury chapters of the PB, included in SBR (3)	(34,543)	(3,489)	0	(3,489)	(8,315)
Offsetting collections net of collections shown in PB	(7,224)	0	(741)	(741)	0
Treasury offsetting receipts shown in other chapters of PB, part of which is in SBR	0	0	198	198	0
Unobligated balance carried forward, recoveries of prior year funds and expired accounts	(1,339)	0	0	0	(35)
Exchange Stabilization Fund resources not shown in PB (4)	(28,919)	0	0	0	(307)
Treasury Financing Accounts (CDFI and ATSB)	(110)	(18)	24	6	(106)
IRS user fees and 50% Transfer Accounts and Capital Transfers to General Fund not included in PB	(108)	0	0	0	0
Other	(2)	(3)	6	3	(3)
Subtotal	**$ (72,245)**	**$ (3,510)**	**$ (513)**	**$ (4,023)**	**$ (8,766)**
Trust Fund – Comptroller of the Currency (OCC) (5)	**0**	**103**	**0**	**103**	**0**
President's Budget Amounts*	**$ 509,417**	**$ 507,377**	**$ (16,673)**	**$ 490,704**	**$ 514,976**

1. These are primarily Earned Income Tax Credit and Child Tax Credit payments that are reported with refunds as custodial activities in Treasury's financial statements and thus are not reported as budgetary resources.
2. These are receipt accounts that Treasury manages on behalf of other agencies and considers to be "General Fund" receipts rather than receipts of the Treasury reporting entity.
3. The largest of these resources relate to Treasury's International Assistance Programs.
4. Exchange Stabilization Fund (ESF) is a self-sustaining component that finances its operations with the buying and selling of foreign currencies to regulate the fluctuations of the dollar. Because of the nature of the activities of the component, it does not receive appropriations, and therefore is excluded from the PB.
5. Negative outlay for OCC included in both Analytical Perspectives and the Appendix.

* Per President's Budget for fiscal year 2009 – Budgetary Resources and Outlays are from the Analytical Perspective. Offsetting Receipts and Obligations Incurred are from the Appendix.

Legal Arrangements Affecting Use of Unobligated Balances

The use of unobligated balances is restricted based on annual legislation requirements or enabling authorities. Funds are presumed to be available for only one fiscal year unless otherwise noted in the annual appropriation language. Unobligated balances in unexpired fund symbols are available in the next fiscal year for new obligations unless some restrictions had been placed on those funds by law. In those situations, the restricted funding will be temporarily unavailable until such time as the reasons for the restriction have been satisfied or legislation has been enacted to remove the restriction.

Amounts in expired fund symbols are not available for new obligations, but may be used to adjust obligations and make disbursements that were recorded before the budgetary authority expired or to meet a bona fide need that arose in the fiscal year for which the appropriation was made.

21. COLLECTION AND DISPOSITION OF CUSTODIAL REVENUE

The Treasury Department collects the majority of federal revenue from income and excise taxes. Collection activity, by revenue type and tax year, was as follows for the fiscal years ended September 30, 2008 and September 30, 2007 (in millions):

	Tax Year				
	2008	2007	2006	Pre-2006	2008 Collections
Individual Income and FICA Taxes	$ 1,455,017	$ 799,244	$ 23,498	$ 16,567	$ 2,294,326
Corporate Income Taxes	222,000	113,949	2,010	16,104	354,063
Estate and Gift Taxes	23	19,248	1,266	9,287	29,824
Excise Taxes	48,106	17,909	119	159	66,293
Railroad Retirement Taxes	3,769	1,164	1	5	4,939
Unemployment Taxes	5,146	2,026	42	117	7,331
Federal Reserve Earnings	25,879	7,719	0	0	33,598
Fines, Penalties, Interest, and Other Revenue	1,936	297	0	0	2,233
Subtotal	**$ 1,761,876**	**$ 961,556**	**$ 26,936**	**$ 42,239**	**$ 2,792,607**
Less Amounts Collected for Non-federal Entities					(407)
Total					**$ 2,792,200**

	Tax Year				
	2007	2006	2005	Pre-2005	2007 Collections
Individual Income and FICA Taxes	$ 1,408,591	$ 750,587	$ 23,861	$ 18,425	$ 2,201,464
Corporate Income Taxes	253,376	116,342	2,938	22,664	395,320
Estate and Gift Taxes	45	16,162	1,571	9,200	26,978
Excise Taxes	49,660	17,807	90	209	67,766
Railroad Retirement Taxes	3,576	1,127	1	14	4,718
Unemployment Taxes	5,198	2,041	51	126	7,416
Federal Reserve Earnings	26,255	5,788	0	0	32,043
Fines, Penalties, Interest, and Other Revenue	2,661	423	0	0	3,084
Subtotal	**$ 1,749,362**	**$ 910,277**	**$ 28,512**	**$ 50,638**	**$ 2,738,789**
Less Amounts Collected for Non-federal Entities					(486)
Total					**$ 2,738,303**

Amounts reported for Corporate Income Taxes collected in fiscal year 2008 include corporate taxes of $10 billion for tax year 2009 (similarly, amounts reported for Corporate Income Taxes collected in fiscal year 2007 include corporate taxes of $10 billion for tax year 2008). Individual Income and FICA Taxes includes $79 billion in payroll taxes collected from other federal agencies ($72 billion in fiscal year 2007).

Amounts Provided to Fund the Federal Government

For the fiscal years ended September 30, 2008 and September 30, 2007, collections of custodial revenue transferred to other entities were as follows (in millions):

	2008	2007
Department of the Interior	$ 312	$ 288
General Fund	2,365,814	2,445,331
Total	**$ 2,366,126**	**$ 2,445,619**

Federal Tax Refunds Paid

Refund activity, broken out by revenue type and by tax year, was as follows for the fiscal years ended September 30, 2008 and September 30, 2007 (in millions):

	Tax Year				
	2008	2007	2006	Pre-2006	2008 Refunds
Individual Income and FICA Taxes	$ 935	$ 342,216	$ 19,217	$ 6,980	$ 369,348
Corporate Income Taxes	2,206	19,610	10,446	22,078	54,340
Estate and Gift Taxes	0	343	428	251	1,022
Excise Taxes	439	497	107	208	1,251
Railroad Retirement Taxes	0	1	1	(9)	(7)
Unemployment Taxes	1	65	14	39	119
Fines, Penalties, Interest, and Other Revenue	1	0	0	0	1
Total	**$ 3,582**	**$ 362,732**	**$ 30,213**	**$ 29,547**	**$ 426,074**

	Tax Year				
	2007	2006	2005	Pre-2005	2007 Refunds
Individual Income and FICA Taxes	$ 1,823	$ 235,151	$ 17,839	$ 6,242	$ 261,055
Corporate Income Taxes	1,241	8,122	4,278	14,509	28,150
Estate and Gift Taxes	0	256	490	223	969
Excise Taxes	416	570	253	1,131	2,370
Railroad Retirement Taxes	0	5	1	7	13
Unemployment Taxes	0	75	16	36	127
Total	**$ 3,480**	**$ 244,179**	**$ 22,877**	**$ 22,148**	**$ 292,684**

Federal Tax Refunds Payable

As of September 30, 2008 and September 30, 2007, refunds payable to taxpayers consisted of the following (in millions):

	2008	2007
Alcohol, Tobacco Tax and Trade Bureau	$ 12	$ 9
Internal Revenue Service	$ 3,064	$ 1,675
Total	**$ 3,076**	**$ 1,684**

22. EARMARKED FUNDS

Earmarked funds are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities or purposes. SFFAS No. 27, *Identifying and Reporting Earmarked Funds,* issued by the FASAB defines the following three criteria for determining an earmarked fund: 1) A statute committing the Federal Government to use specifically identified revenues and other financing sources only for designated activities, benefits or purposes; 2) Explicit authority for the earmarked fund to retain revenues and other financing sources not used in the current period for future use to finance the designated activities, benefits, or purposes; and 3) A requirement to account for and report on the receipt, use, and retention of the revenues and other financing sources that distinguishes the earmarked fund from the government's general revenues.

The majority of Treasury's earmarked fund activities are attributed to the ESF and the pension and retirement funds managed by the Office of DCP. In addition, several Treasury bureaus operate with "public enterprise revolving funds" and receive no appropriations from the Congress. These bureaus are BEP, U.S. Mint, OCC, and OTS. Other miscellaneous earmarked funds are managed by BPD, DO, FMS, and TFF.

The following is a list of earmarked funds and a brief description of the purpose, accounting, and uses of these funds.

Exchange Stabilization Fund (ESF)

ESF	20X4444	Exchange Stabilization Fund

D.C. Pensions

DCP	20X1713	Federal payment – D.C. Judicial Retirement
DCP	20X1714	Federal payment – D.C. Federal Pension Fund
DCP	20X5511	D.C. Federal Pension Fund
DCP	20X8212	D.C. Judicial Retirement and Survivor's Annuity Fund

Public Enterprise Revolving Funds

BEP	20X4502	Bureau of Engraving and Printing Public Enterprise Fund
MNT	20X4159	Public Enterprise Revolving Fund
OCC	20X8413	Assessment Funds
OTS	20X4108	Public Enterprise Revolving Fund
IRS	20X4413	Federal Tax Lien Revolving Fund

Other Earmarked Funds

BPD	2061738	Payments to the Terrestrial Wildlife Habitat Restoration
BPD	2071738	Payments to the Terrestrial Wildlife Habitat Restoration
BPD	2081738	Payments to the Terrestrial Wildlife Habitat Restoration
BPD	20X5080	Gifts to Reduce Public Debt
BPD	20X5080.001	Receipt of Gifts to Reduce Public Debt
BPD	20X8207	Lower Brule Sioux Tribe Terrestrial Wildlife Habitat Restoration Trust Fund
BPD	20X8209	Cheyenne River Sioux Terrestrial Wildlife Habitat Restoration Trust Fund
DO	20X5407	Sallie Mae Assessments
DO	20X5816	Confiscated and Vested Iraqi Property and Assets

DO	20X8790	Gifts and Bequests Trust Fund
FMS	205445	Debt Collection
FMS	20X5081	Presidential Election Campaign
FMS	20X8902	Esther Cattell Schmitt Gift Fund
FMS	202/35445	Debt Collection Special Fund
FMS	203/45445	Debt Collection Special Fund
FMS	204/55445	Debt Collection Special Fund
FMS	205/65445	Debt Collection Special Fund
FMS	206/75445	Debt Collection Special Fund
FMS	207/85445	Debt Collection Special Fund
FMS	208/95445	Debt Collection Special Fund
IRS	20X5510	Private Collection Agent Program
TFF	20X5697	Treasury Forfeiture Fund

The ESF uses funds to purchase foreign currencies, to hold U.S. foreign exchange and SDR assets, and to provide financing to foreign governments. ESF accounts and reports its holdings to FMS on the SF224, "Statement of Transactions," as well as to the Congress and Treasury's policy office. The Gold Reserve Act of 1934, Bretton Woods Agreement Act of 1945, P.L. 95-147 and P.L. 94-564 established and authorized the use of the Fund. SDR in the IMF, Investments in U.S. Securities (BPD), and Investments in Foreign Currency Denominated assets are the sources of revenues or other financing sources. ESF's earnings and realized gains on foreign currency denominated assets represent inflows of resources to the government, and the revenues earned are the result of intra-governmental inflows.

D.C. Pension Funds provide annuity payments for retired D.C. teachers, police officers, judges, and firefighters. The sources of revenues are through annual appropriations, employees' contributions, and interest earnings from investments. All proceeds are earmarked. Note 15 provides detailed information on various funds managed by the Office of DCP.

Treasury's four non-appropriated bureaus, BEP, Mint, OCC, and OTS, operate "public enterprise funds" that account for the revenue and expenses related to the production and sale of numismatic products and circulating bureaus coinage (Mint), the currency printing activities (BEP), and support of oversight functions of banking (OCC) and thrift operations (OTS). 31 USC 142 established the revolving fund for BEP to account for revenue and expenses related to the currency printing activities. Public Law 104-52 (31 USC §5136) established the Public Enterprise Fund for the Mint to account for all revenue and expenses related to the production and sale of numismatic products and circulating coinage. Revenues and other financing sources at the Mint are mainly from the sale of numismatic and bullion coins, and the sale of circulating coins to the Federal Reserve Banks system. 12 USC 481 established the Assessment Funds for OCC, and 103 Stat. 278 established the Public Enterprise Revolving Fund for OTS. Revenue and financing sources are from the bank examination and assessments for the oversight of the national banks, savings associations, and savings and loan holding companies. These earmarked funds do not directly contribute to the inflows of resources to the government; however, revenues in excess of costs are returned to the General Fund of the U.S. Government. There are minimal transactions with other government agencies.

There are other earmarked funds at several Treasury Department bureaus, such as donations to the Presidential Election Campaign Fund, funds related to the debt collection program, gifts to reduce the public debt, and other enforcement related activities. Public laws, statutory laws, U.S. Code, and the Debt Collection Improvement Act

established and authorized the use of these funds. Sources of revenues and other financing sources include contributions, cash and property forfeited in enforcement activities, public donations, and debt collection.

Intra-governmental Investments in Treasury Securities

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. Treasury bureaus and other federal agencies invest some of the earmarked funds that they collect from the public. The funds are invested in securities issued by Treasury's Bureau of the Public Debt (BPD). The cash collected by BPD is deposited in the General Fund of the U.S. Government, which uses the cash for general government purposes.

The investments provide the Treasury Department bureaus and other federal agencies with authority to draw upon the General Fund of the U.S. Government to make future benefit payments or other expenditures. When Treasury Department bureaus or other federal agencies require redemption of these securities to make expenditures, the government finances those expenditures out of accumulated cash balances, by raising taxes or other receipts, by borrowing from the public or repaying less debt, or by curtailing other expenditures. This is the same way that the government finances all other expenditures.

The securities are an asset to the Treasury Department bureaus and other federal agencies and a liability of the BPD. The General Fund of the U.S. Government is liable to BPD. Because Treasury Department bureaus and other federal agencies are parts of the U.S. Government, these assets and liabilities offset each other from the standpoint of the government as a whole. For this reason, they do not represent an asset or a liability in the U.S. Government-wide financial statements.

The balances related to the investments made by Treasury Department bureaus are not displayed on Treasury's consolidated financial statements because the bureaus are subcomponents of the Treasury Department. However, the General Fund of the U.S. Government remains liable to BPD for the invested balances and BPD remains liable to the investing Treasury Department bureaus (Note 4).

Summary Information for Earmarked Funds as of and for the Year ended September 30, 2008 (In Millions):

	Exchange Stabilization Fund	D.C. Pensions	Public Enterprise Revolving Funds	Other Earmarked Funds	Combined Earmarked Funds	Eliminations*	09/30/2008 Totals
Balance Sheet							
ASSETS:							
Fund Balance	$ 33	$ 0	$ 459	$ 228	$ 720	$ 0	$ 720
Investments/Related Interest – Intra-governmental	16,847	3,859	1,251	592	22,549	22,549	0
Cash, Foreign Currency/Other Monetary Assets	22,221	0	0	16	22,237	0	22,237
Investments and Related Interest	10,543	0	0	0	10,543	0	10,543
Other Assets	298	16	1,292	133	1,739	9	1,730
Total Assets	**$ 49,942**	**$ 3,875**	**$ 3,002**	**$ 969**	**$ 57,788**	**$ 22,558**	**$ 35,230**
LIABILITIES:							
Intra-governmental Liabilities	$ 0	$ 0	$ 37	$ 150	$ 187	$ 29	$ 158
Certificates Issued to Federal Reserve	2,200	0	0	0	2,200	0	2,200
Allocation of Special Drawing Rights	7,630	0	0	0	7,630	0	7,630
Other Liabilities	330	8,856	617	182	9,985	0	9,985
Total Liabilities	**$ 10,160**	**$ 8,856**	**$ 654**	**$ 332**	**$ 20,002**	**$ 29**	**$ 19,973**
NET POSITION:							
Unexpended Appropriations	$ 200	$ 0	$ 0	$ 0	$ 200	$ 0	$ 200
Cumulative Results of Operations	39,582	(4,981)	2,348	637	37,586	0	37,586
Total Liabilities and Net Position	**$ 49,942**	**$ 3,875**	**$ 3,002**	**$ 969**	**$ 57,788**	**$ 29**	**$ 57,759**
Statement of Net Cost							
Gross Cost	$ 250	$ 339	$ 3,496	$ 337	$ 4,422	$ 62	$ 4,360
Less Earned Revenue	(1,986)	(152)	(3,593)	(6)	(5,737)	(650)	(5,087)
Total Net Cost of Operations	**$ (1,736)**	**$ 187**	**$ (97)**	**$ 331**	**$ (1,315)**	**$ (588)**	**$ (727)**
Cumulative Results of Operations							
Beginning Balance	$ 37,846	$ (5,141)	$ 2,206	$ 474	$ 35,385	$ 0	$ 35,385
Budgetary Financing Sources	0	347	0	442	789	23	766
Other Financing Sources	0	0	45	52	97	(31)	128
Total Financing Sources	0	347	45	494	886	(8)	894
Net Cost of Operations	1,736	(187)	97	(331)	1,315	588	727
Net Change	1,736	160	142	163	2,201	580	1621
Total Cumulative Results of Operations	**$ 39,582**	**$ (4,981)**	**$ 2,348**	**$ 637**	**$ 37,586**	**$ 580**	**$ 37,006**

* The eliminations reported above include both inter and intra eliminations for the Earmarked Funds. The total eliminations amount will not agree with the eliminations reported in the Statement of Changes in Net Position, which include eliminations for Other Funds.

Summary Information for Earmarked Funds as of and for the Year ended September 30, 2007 (In Millions):

	Exchange Stabilization Fund	D.C. Pensions	Public Enterprise Revolving Funds	Other Earmarked Funds	Combined Earmarked Funds	Eliminations*	09/30/2007 Totals
Balance Sheet							
ASSETS:							
Fund Balance	$ 0	$ 0	$ 439	$ 265	$ 704	$	$ 704
Investments/Related Interest – Intra-governmental	16,439	3,856	1,124	482	21,901	21,901	0
Cash, Foreign Currency/Other Monetary Assets	21,445	0	0	28	21,473		21,473
Investments and Related Interest	10,040	0	0	0	10,040		10,040
Other Assets	0	45	1,259	90	1,394	10	1,384
Total Assets	**$ 47,924**	**$ 3,901**	**$ 2,822**	**$ 865**	**$ 55,512**	**$ 21,911**	**$ 33,601**
LIABILITIES:							
Intra-governmental Liabilities	$ 0	$ 0	$ 24	$ 198	$ 222	$ 13	$ 209
Certificates Issued to Federal Reserve	2,200	0	0	0	2,200		2,200
Allocation of Special Drawing Rights	7,627	0	0	0	7,627		7,627
Other Liabilities	51	9,042	592	193	9,878		9,878
Total Liabilities	**$ 9,878**	**$ 9,042**	**$ 616**	**$ 391**	**$ 19,927**	**$ 13**	**$ 19,914**
NET POSITION:							
Unexpended Appropriations	$ 200	$ 0	$ 0	$ 0	$ 200		$ 200
Cumulative Results of Operations	37,846	(5,141)	2,206	474	35,385		35,385
Total Liabilities and Net Position	**$ 47,924**	**$ 3,901**	**$ 2,822**	**$ 865**	**$ 55,512**	**$ 13**	**$ 55,499**
Statement of Net Cost							
Gross Cost	$ 703	$ 446	$ 2,997	$ 234	$ 4,380	$ 56	$ 4,324
Less Earned Revenue	(3,864)	(160)	(3,120)	0	(7,144)	(1,036)	(6,108)
Total Net Cost of Operations	**$ (3,161)**	**$ 286**	**$ (123)**	**$ $234**	**$ (2,764)**	**$ (980)**	**$ (1,784)**
Cumulative Results of Operations							
Beginning Balance	$ 34,685	$ (5,209)	$ 1,816	$ 322	$ 31,614	$ 0	$ 31,614
Budgetary Financing Sources	$ 0	$ 354	$ 0	$ 354	$ 708	$ 40	$ 668
Other Financing Sources	0	0	267	32	299	(16)	315
Total Financing Sources	0	354	267	386	1,007	24	983
Net Cost of Operations	3,161	(286)	123	(234)	2,764	980	1,784
Net Change	3,161	68	390	152	3,771	1,004	2,767
Total Cumulative Results of Operations	**$ 37,846**	**$ (5,141)**	**$ 2,206**	**$ 474**	**$ 35,385**	**$ 1,004**	**$ 34,381**

* The eliminations reported above include both inter and intra eliminations for the Earmarked Funds. The total eliminations amount will not agree with the eliminations reported in the Statement of Changes in Net Position, which include eliminations for Other Funds.

23. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

The Reconciliation of Net Cost of Operations to Budget explains the difference between the budgetary net obligations and the proprietary net cost of operations. For fiscal years 2008 and 2007, OMB did not prescribe a format for this reconciliation in OMB Circular A-136, *Financial Reporting Requirements,* as amended, so that preparers might develop a more robust presentation tailored to their agency. As of September 30, 2008 and September 30, 2007, the Reconciliation of Net Cost of Operations to Budget consisted of the following (in millions):

	2008	2007
RESOURCES USED TO FINANCE ACTIVITIES:		
Budgetary Resources Obligated:		
Obligations Incurred	$ 487,534	$ 465,530
Less: Spending Authority from Offsetting Collections and Recoveries	(9,401)	(10,237)
Obligations Net of Offsetting Collections and Recoveries	478,133	455,293
Less: Offsetting Receipts	(16,211)	(16,040)
Net Obligations	**$ 461,922**	**$ 439,253**
Other Resources:		
Donations and Forfeiture of Property	112	73
Financing Sources for Accrued and Discount on the Debt	(3,870)	7,632
Transfers In/Out Without Reimbursement	(21)	(24)
Imputed Financing from Cost Absorbed by Others	729	740
Transfers to the General Fund and Other (Note 18)	(20,788)	(12,293)
Net Other Resources Used to Finance Activities	(23,838)	(3,872)
GSE Transactions	13,800	0
Total Resources Used to Finance Activities	**$ 451,884**	**$ 435,381**
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS:		
Change in Budgetary Resources Obligated for Goods, Services, and Benefits Ordered but not yet Provided	$ 1,229	$ 4,788
Credit Program Collections that Increase Liabilities for Loans Guarantees or Allowances for Subsidy	(5)	(94)
Adjustment to Accrued Interest and Discount on the Debt	(6,731)	4,385
Other (primarily non-exchange portion of offsetting receipts)	(10,745)	(14,089)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(16,252)	(5,010)
Total Resources Used to Finance the Net Cost of Operations	**$ 468,136**	**$ 440,391**
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	14	(18)
Total Components of Net Cost of Operations that will not Require or Generate Resources	1,201	948
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	**1,215**	**930**
Net Cost of Operations	**$ 469,351**	**$ 441,321**

24. SPECIAL PROGRAMS WITH GOVERNMENT SPONSORED ENTERPRISES (GSE)

Steps Taken to Maintain Financial Stability of GSE

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are stockholder-owned GSE. Congress established these GSE to increase the supply of mortgage loans and to reduce the accompanying costs. A key Fannie Mae and Freddie Mac responsibility is to package purchased mortgages into securities. These securities are subsequently sold to investors. Proceeds from Fannie Mae and Freddie Mac sales are used to buy additional mortgages and keep money flowing through the mortgage markets. Fannie Mae and Freddie Mac direct, guaranteed debt, and mortgage backed securities (MBS) outstanding totaled approximately $5 trillion dollars at September 30, 2008.

Increasingly difficult conditions in the housing market challenged the soundness and profitability of MBS, thereby undermining the entire housing market. This led Congress to pass the Housing and Economic Recovery Act of 2008 in July 2008 (HERA). This Act created the new Federal Housing Finance Agency (FHFA), with enhanced regulatory authority over the GSE, and provided the Secretary of the Treasury with certain authorities intended to ensure the financial stability of the GSE, if necessary.

Due to deteriorating conditions in the housing mortgage markets and the resulting negative financial impact on the GSE, they were placed under FHFA conservatorship on September 7, 2008. This action was taken to preserve GSE assets, ensure a sound and solvent financial condition, and mitigate systemic risks that contributed to market instability. The FHFA director will terminate the conservatorship once sound and solvent conditions are established.

Pursuant to the authorities provided to the Secretary under the HERA, the Treasury Department, also on September 7, 2008, took three additional steps discussed below to help ensure the liquidity of the GSE while they are working to resolve their financial difficulties.

Senior Preferred Stock Purchase Agreements

The first step was entering into senior preferred stock purchase agreements with each GSE on September 7, 2008. In exchange for entering into these agreements, Treasury Department initially received from each GSE: (1) 1,000,000 shares of non-voting variable liquidation preference senior preferred stock with a liquidation preference value of $1,000 per share and (2) a non-transferrable warrant for the purchase at a nominal cost of 79.9percent of common stock on a fully-diluted basis. The warrants expire on September 7, 2028. The senior preferred stock accrues dividends at 10percent per year, payable quarterly. This rate shall increase to 12percent if, in any quarter, the dividends are not paid in cash, until all accrued dividends have been paid. In addition, beginning on March 31, 2010, the GSE will pay the Treasury Department a periodic commitment fee on a quarterly basis. This commitment fee will compensate the Treasury Department for the explicit support provided by the preferred stock agreements. This fee will be initially set by December 31, 2009, based on mutual agreement between the Treasury Department and each GSE, in consultation with the Chairman of the Federal Reserve Board. The fee shall be established for five-year periods, and may be waived by the Treasury Department for one year at a time if warranted by adverse mortgage market conditions. It may be paid in cash or may be added to the liquidation preference.

The senior preferred stock and warrants received in fiscal year 2008 are accounted for as non-entity investments in the Treasury Department's Fiscal Year 2008 Performance and Accountability Report. Their combined estimated value at September 08, 2008, is $7,032 million and at September 30, 2008, is $12,374 million. As these investments are accounted for at their fair value at the date of receipt, no increase in fair value is recorded. Other Federal Revenue of $7,032 was recognized from the acquisition of preferred stock and warrants. Treasury recorded the investment using the appraisal value $7,032 million at the date of purchase September 8, 2008, and then subsequently used the valuation $12,371 million at the reporting date to determine that no permanent impairment had occurred. Therefore, the recorded amount remained at the historical appraised value.

These agreements, which have no expiration date, provide that the Treasury Department will increase its investment in the senior preferred stock if at the end of any quarter the FHFA determines that the liabilities of either GSE exceed its assets. The maximum amount available to each GSE under this agreement is $100 billion. The Department determined that the net present value of this potential liability cannot be measured with sufficient reliability for fiscal year 2008. Accordingly, the estimated future liability, which would take into account increases in preferred stock liquidity value, associated dividends, and future commitment fees, is not recorded in the financial statements. The Department will attempt to make this determination on at least an annual basis going forward.

The actual recorded liability arising from the reported excess of GSE liabilities over assets as of September 30, 2008, is $ 13.8 billion. This amount is also recorded as an expense for fiscal year 2008. As funds for these payments are appropriated directly to the Department, these payments are treated as entity expenses and reflected as such on the Statement of Net Cost and Cumulative Results of Operations. The payment of this liability in fiscal year 2009 will result in an increase to the nonentity investment in GSE preferred stock, with a corresponding increase in Due to the General Fund, as the Department holds the investment on behalf of the General Fund. The carrying value of the investment will be evaluated on at least an annual basis.

The full amount of the $100 billion for each GSE, totaling $200 billion, was appropriated in fiscal year 2008, and accounts for the increase in appropriated funds and the increase in Unobligated Balance Available as seen in Note 2.

GSE Credit Facility

The second step was the establishment of the Government Sponsored Enterprise Credit Facility (GSECF) to ensure credit availability to the GSE and the Federal Home Loan Banks. This lending facility will provide secured funding on an as needed basis under terms and conditions established by the Secretary to protect taxpayers. Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are eligible to borrow under this program. The GSECF provides liquidity, if needed, until December 31, 2009.

Funding will be provided directly by Treasury from its account held at the Federal Reserve Bank of New York (FRBNY) in exchange for eligible collateral from the GSE which will be limited to guaranteed mortgage backed securities issued by the GSE as well as advances made by the Federal Home Loan Banks. Loan requests will require approval from Treasury and verification by the FRBNY that adequate collateral has been pledged. Loans made through the GSECF are subject to the federal debt limit. Loans will be for short-term durations and are in general expected to be for less than one month but no shorter than one week. Loans will not be made with a maturity date beyond December 31, 2009. The rate on a loan request ordinarily will be based on the daily London Interbank Borrowing Rate (LIBOR) for a similar term loan plus 50 basis points. The rate is set at the discretion of the Secretary with the objective of protecting the taxpayer, and is subject to change.

There is no stated limitation on loans provided through the GSECF. However, loans are limited to the amounts of available collateral.

There were no loans made through the GSECF in fiscal year 2008.

GSE Mortgage-Backed Securities Purchase Program

The third step was the initiation of a temporary program to further support the availability of mortgage financing for millions of Americans and to mitigate pressures on mortgage rates. Under this program, Treasury purchases GSE MBS in the open market. By purchasing these credit-guaranteed securities, Treasury seeks to broaden access to mortgage funding for current and prospective homeowners and to promote stability in the mortgage market.

The size and timing of the MBS purchases is subject to the discretion of the Secretary. The scale of the program will be based on developments in the capital and housing markets. Initial purchases of $3.3 billion were made during September 2008. Additional purchases will be made as deemed appropriate through the expiration of this authority on December 31, 2009.

As these securities are backed by individual mortgages, they are accounted for under the Credit Reform Act of 1990.

25. TEMPORARY GUARANTEE PROGRAM FOR MONEY MARKET FUNDS

The Treasury Department has established a Temporary Guarantee Program (Program) for Money Market Funds. Under this Program the Treasury Department will guarantee to investors that they will receive the stable share price (SSP) for shares held in participating money market funds as of the close of business on September 19, 2008. President George W. Bush approved the use of existing authorities by Secretary Henry M. Paulson, Jr. to make available, as necessary, the assets of the Exchange Stabilization Fund (ESF) to support the Program. If a participating fund's market-based net asset value (NAV) falls below 99.5 percent of the SSP and is not cured, a Guarantee Event will be deemed to occur. If outlays become necessary, they would be paid out initially from the ESF, and then under the provisions of Section 131 of the Emergency Economic Stabilization Act of 2008, such outlays would be reimbursed from funds available under the Troubled Assets Relief Program (Note 26). Treasury is not currently aware of any Guarantee Events which have occurred at funds that have been accepted into the Program.

Eligible funds must be regulated under Rule 2a-7 of the Investment Company Act of 1940, must maintain a SSP, must have had a market-based NAV of at least 99.5 percent of the SSP as of September 19, 2008, and must be publicly offered and registered with the Securities and Exchange Commission. The Program will be in effect until December 18, 2008, with an option to extend until September 18, 2009, at the discretion of the Secretary of the Treasury.

To participate in the Program, eligible money market funds must submit an application and pay a premium of one basis point if the fund's NAV is greater than or equal to 99.75 percent of the SSP, or 1.5 basis points of the SSP if the fund's NAV is less than 99.75 percent of the SSP but greater than or equal to 99.50 percent of the SSP. If the Program is extended beyond December 18, new premium charges will apply and funds will have the option to renew their coverage.

As of September 30, 2008, the Department collected $39.7 million in program participation premiums. As of October 10, 2008, the Department collected an additional $298.1 million in premiums. These premiums represent the payments for the first three months of coverage which began September 19, 2008. All premium payments were invested into U.S. Government securities. Treasury received applications representing at least $3 trillion of assets under management before the application deadline. As Treasury is currently reviewing the applications and determining eligibility for inclusion in the Program, the final assets under management that will be covered by the Program has not been determined. In addition, program participation payments from funds that are not accepted into the Program will be returned. Of the total $337.8 million collected, $45.0 million was recognized as earned revenue, while $292.8 million remained as unearned revenue at September 30, 2008. The revenue is included in Economic Program earned revenue on the Statement of Net Cost. The unearned revenue is included in other liabilities on the Balance Sheet.

The Department of the Treasury's exposure under the Program, when a guarantee event occurs, is the difference between the SSP and the NAV at liquidation of the money market fund. The Department believes the risk of loss under the program is negligible, and no future liability is recorded at September 30, 2008.

26. SUBSEQUENT EVENTS

A. Emergency Economic Stabilization Act of 2008

The Emergency Economic Stabilization Act of 2008 (EESA) was signed into law on October 3, 2008. This law establishes a Troubled Asset Relief Program (TARP) to be administered by the Department of the Treasury. The TARP is intended to promote market stability and protect the U.S. economy by authorizing Treasury to purchase and guarantee troubled mortgage-related assets and other financial assets. EESA also provides for the purchase of any other financial instruments that the Secretary determines, after consultation with the Federal Reserve Board Chairman, is necessary in order to promote financial market stability.

The Secretary's authority to purchase financial assets was limited initially to $250 billion in outstanding assets, and increased to $350 billion upon certification by the President to the Congress on October 14, 2008. The authority can be increased to the maximum of $700 billion upon submission of a written report from the President to the Congress detailing the Secretary's plan to exercise additional authority, providing Congress does not enact a law to remove the President's authority.

The $700 billion limit shall be reduced by the difference between outstanding guaranteed obligations under the insurance program authorized by EESA, if any, and the balance in the Troubled Assets Insurance Financing Fund (TAIFF) established by EESA to guarantee timely payments on mortgage-related assets. The Secretary can guarantee timely payment of up to 100percent of the principal and interest on these insured assets. Institutions seeking this guarantee are required to pay risk-based premiums into the fund. The premiums will be in amounts determined by the Secretary, as necessary, to meet anticipated claims and eliminate any budgetary cost.

The EESA legislation terminates on December 31, 2009. However, the Secretary can extend this authority to October 3, 2010 upon submission of a written certification to Congress. EESA increases the statutory public debt limit by $700 billion, from $10.615 trillion to $11.315 trillion.

Upon passage of EESA, Treasury established the Office of Financial Stability to administer the TARP. No EESA transactions occurred during fiscal year 2008. Through November 14, 2008, $148 billion in financial assets were purchased through TARP.

B. Energy Improvement and Extension Act of 2008

P.L. 110-343, *Division B - Energy Improvement and Extension Act of 2008*, was enacted on October 3, 2008.

Section 113 of the Act allowed for the restructuring of the Advance to the Black Lung Trust Fund (the Fund) by the repayment of the market value of outstanding repayable advances with the proceeds of obligations issued by the Fund to the General Fund of the U.S. Government and a one time appropriation.

Effective October 7, 2008, the Black Lung Disability Trust Fund repaid the General Fund of the U.S. Government the market value of the outstanding repayable plus accrued interest by transferring (1) obligations whose denominations, rate, and maturity were prescribed by the Secretary of the Treasury and (2) the one time appropriation amount, which was the difference between the proceeds received from issuance of the obligations described above and the market value of the outstanding advances payable.

C. American International Group (AIG)

To help AIG work out its financial difficulties, the Federal Reserve Bank of New York agreed to lend up to $85 billion to AIG pursuant to the authority in Section 13(3) of the Federal Reserve Act. The Department is not a party to the AIG credit facility with the Fed, and has no liabilities, commitments or guarantees pursuant to the Fed's arrangements with AIG or any other financial relationship with AIG.

Under the terms of the agreement with AIG and the Federal Reserve, an approximately 79.9 percent equity interest in AIG (in the form of Convertible Participating Serial Preferred Stock convertible into approximately 79.9 percent of the issued and outstanding shares of common stock) was to be issued to a trust to be established by AIG. The U.S. Treasury will be named as the beneficiary of that trust, so that when the stock is ultimately liquidated the proceeds will be deposited into the General Fund of the U.S. Government. The Treasury Department will be the recipient of any dividends and any proceeds from the liquidation of the stock on behalf of the General Fund. The accounting and reporting for any activities related to the government's interest in the stock held by the trust will be done by the Treasury Department.

Subsequent to September 30, 2008, the credit facility to assist AIG was restructured significantly. The credit facility was modified to be incorporated into the TARP described above. To provide additional financial assistance to AIG, the Department agreed in November 2008 to directly purchase $40 billion in senior AIG preferred stock through the TARP. The Treasury Department will also receive common stock warrants for 2 percent of the outstanding AIG common stock, with the above-described convertible preferred stock interest to be owned by the trust reduced to 77.9 percent.

REQUIRED SUPPLEMENTAL INFORMATION (UNAUDITED)

Introduction

This section provides the Required Supplemental Information as prescribed by Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements*.

Other Claims for Refunds

The Treasury Department has estimated that $22 billion may be payable as other claims for tax refunds. This estimate represents amounts (principal and interest) that may be paid for claims pending judicial review by the federal courts or internally. The total estimated payout (including principal and interest) for claims pending judicial review by the federal courts is $5.0 billion and by appeals is $17 billion.

Federal Taxes Receivable, Net

In accordance with SFFAS No. 7, some unpaid tax assessments do not meet the criteria for financial statement recognition as discussed in Note 1 to the financial statements. Although compliance assessments and write-offs are not considered receivables under federal accounting standards, they represent legally enforceable claims of the Federal Government. There is, however, a significant difference in the collection potential between compliance assessments and receivables.

The components of the total unpaid assessments at September 30, 2008, were as follows (in billions):

Total Unpaid Assessments	$	278
Less: Compliance Assessments		(67)
Write Offs		(99)
Gross Federal Taxes Receivable	**$**	**112**
Less: Allowance for Doubtful Accounts		(83)
Federal Taxes Receivables, Net	**$**	**29**

To eliminate double counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $4 billion, assessed against officers and directors of businesses who were involved in the non-remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the Treasury Department may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

Internal Revenue Service (IRS)

The unpaid assessments balance represents assessments resulting from taxpayers filing returns without sufficient payment, as well as from the IRS's enforcement programs such as examination, under-reporter, substitute for return, and combined annual wage reporting. A significant portion of this balance is not considered a receivable. Also, a substantial portion of the amounts considered receivables is largely uncollectible.

Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Due to the lack of agreement, these compliance assessments are less likely to have future collection potential than those unpaid assessments that are considered federal taxes receivable.

Assessments with little or no future collection potential are called write-offs. Write-offs principally consist of amounts owed by deceased, bankrupt, or defunct taxpayers, including many failed financial institutions liquidated by the FDIC and the former Resolution Trust Corporation (RTC). As noted above, write-offs have little or no future collection potential, but statutory provisions require that these assessments be maintained until the statute for collection expires.

Deferred Maintenance

In fiscal year 2008, the Treasury Department had no material amounts of deferred maintenance costs to report on vehicles, buildings, and structures owned by the Department of the Treasury.

Deferred maintenance applies to owned PP&E. Deferred maintenance is maintenance that was not performed when it should have been, or was scheduled to be, and is put off or delayed for a future period. Maintenance is defined as the act of keeping capitalized assets in an "acceptable condition" to serve their required mission. It includes preventive maintenance, normal repairs, replacement of parts and structural components, and other activities needed to preserve the asset so that it continues to provide acceptable services and achieves its expected useful life. Maintenance excludes activities aimed at expanding the capacity or significantly upgrading the assets to a different form than it was originally intended (*i.e.*, activities related to capitalized improvements, modernization, and/or restoration).

Logistic personnel use condition assessment surveys and/or the total life-cycle cost methods to determine deferred maintenance and acceptable operating condition of an asset. Periodic condition assessments, physical inspections, and review of manufacturing and engineering specifications, work orders, and building and other structure logistics reports can be used under these methodologies.

Money Market Insurance Program– Risk Assumed Disclosure

The Treasury Department is not recording a contingent liability for any risk assumed, because the Department of the Treasury's exposure under the Program is the difference between a stable share price and the net asset value at liquidation of the money market fund. For all of the reasons outlined in Note 25, and based on current information and the Federal programs in place, and as this is a temporary program dealing with issues of first impression, we believe the risk of loss to the Treasury Department is negligible.

Liquidity Commitment to Government Sponsored Enterprises (GSEs)

The liquidity commitment to the GSEs described in the senior preferred stock purchase agreements section of Note 24 is essentially an insurance program in that the Treasury Department received a commitment fee in return for a guarantee of GSE liquidity should their liabilities exceed their assets at the end of any future quarter.

The total program liability as of September 30, 2008 should include the amount of quarterly liquidity draws requested but not yet paid, accruals for amounts of liquidity draws not known until after the end of the quarter, and an estimated contingent liability for the discounted present value of future liquidity draws up to the $200 billion combined liability limit. The discounted present value would take into account estimated offsetting increases in the liquidity preference of the preferred stock, increases in dividends on the increased liquidity preference, and annual commitment fees. However, due to the current uncertainties and turbulence in the financial markets, for fiscal year 2008 the estimated contingent liability amount does not have "sufficient reliability" to be recorded as a liability. The only liability that is recorded for fiscal year 2008 is the $13.8 billion draw request received from the Federal Housing Finance Agency on behalf of Freddie Mac in November 2008 for the quarter ended September 30, 2008. As noted above, the total gross risk under this commitment was $200 billion; after the November draw request, the remaining commitment is $186.2 billion.

Fiscal Year 2008 Statement of Budgetary Resources Disaggregated by Sub-organization Accounts (in Millions):

	Engraving and Printing	Bureau Public Debt	Departmental Offices	Fin. Crimes Enforcement Network	Financial Management Service	Internal Revenue Service
Budgetary Resources						
Unobligated balance brought forward	$ 112	$ 131	$ 55,288	$ 11	$ 259	$ 662
Recoveries prior year unpaid obligations	0	125	133	2	15	105
Budget Authority:						
Appropriations	0	452,780	203,289	86	12,018	11,296
Borrowing authority	0	0	4	0	0	0
Spending authority offsetting collections:						
Earned: Collected	509	334	4,405	2	239	144
Change in receivable federal	8	(73)	2	1	2	28
Change in unfilled customer order:						
Advance received	5	0	(4)	0	0	0
Without advance from federal sources	0	(37)	6	2	(8)	(3)
Subtotal	522	453,004	207,702	91	12,251	11,465
Non-expenditure transfers, net	0	(2)	846	0	(18)	18
Temporarily not available	0	(5)	(4)	0	0	0
Permanently not available	0	(1,303)	(1,027)	(1)	(2,210)	(68)
Total Budgetary Resources	**$ 634**	**$ 451,950**	**$ 262,938**	**$ 103**	**$ 10,297**	**$ 12,182**
Status of Budgetary Resources						
Obligations incurred						
Direct	$ 0	$ 451,458	$ 4,544	$ 80	$ 9,847	$ 11,360
Reimbursable	538	317	511	4	211	140
Subtotal	538	451,775	5,055	84	10,058	11,500
Unobligated Balance						
Apportioned	96	144	213,380	15	212	217
Exempt from apportionment	0	23	33,932	0	18	0
Subtotal	96	167	247,312	15	230	217
Unobligated balance not available	0	8	10,571	4	9	465
Total Status of Budgetary Resources	**$ 634**	**$ 451,950**	**$ 262,938**	**$ 103**	**$ 10,297**	**$ 12,182**
Relationship Obligations to Outlays						
Obligated balance, net						
Unpaid obligations brought forward	$ 102	$ 297	$ 55,202	$ 16	$ 332	$ 1,440
Uncollected customer payments Federal sources brought forward	(39)	(299)	(9)	0	(39)	(22)
Total unpaid obligated balance, net	63	(2)	55,193	16	293	1,418
Obligations incurred, net	538	451,775	5,055	84	10,058	11,500
Gross Outlays	(536)	(451,788)	(5,335)	(85)	(10,046)	(11,399)
Recoveries prior year unpaid obligations	0	(125)	(133)	(2)	(15)	(105)
Change uncollected customer payments	(8)	110	(8)	(3)	6	(25)
Obligated balance net, end of period						
Unpaid obligations	103	159	54,789	13	329	1,436
Uncollected customer payments federal	(46)	(189)	(17)	(3)	(33)	(47)
Total unpaid obligated balance, net	57	(30)	54,772	10	296	1,389
Net Outlays						
Gross outlays	536	451,788	5,335	85	10,046	11,399
Offsetting collections	(514)	(334)	(3,871)	(2)	(239)	(144)
Distributed offsetting receipts	0	(14,789)	(236)	0	(986)	(200)
Net Outlays	**$ 22**	**$ 436,665**	**$ 1,228**	**$ 83**	**$ 8,821**	**$ 11,055**

	U.S. Mint	Office of the Comptroller of the Currency	Office of Thrift Supervision	Alcohol Tobacco Tax & Trade Bureau	Budgetary Total	9/30/2008 Non-Budgetary Financing
Budgetary Resources						
Unobligated balance brought forward	$ 53	$ 668	$ 263	$ 3	$ 57,450	$ 0
Recoveries prior year unpaid obligations	27	0	3	3	413	0
Budget Authority:						
Appropriations	0	0	0	94	679,563	0
Borrowing authority	0	0	0	0	4	34,304
Spending authority offsetting collections:						
Earned: Collected	2,066	740	263	3	8,705	335
Change in receivable federal	0	0	0	0	(32)	0
Change in unfilled customer order:						
Advance received	9	0	9	0	19	0
Without advance from federal sources	1	0	0	0	(39)	0
Subtotal	2,076	740	272	97	688,220	34,639
Non-expenditure transfers, net	0	0	0	0	844	0
Temporarily not available	0	0	0	0	(9)	0
Permanently not available	(15)	0	0	(2)	(4,626)	(4,767)
Total Budgetary Resources	**$ 2,141**	**$ 1,408**	**$ 538**	**$ 101**	**$ 742,292**	**$ 29,872**
Status of Budgetary Resources						
Obligations incurred						
Direct	$ 0	$ 0	$ 0	$ 95	$ 477,384	$ 5,415
Reimbursable	2,091	674	246	3	4,735	0
Subtotal	2,091	674	246	98	482,119	5,415
Unobligated Balance						
Apportioned	50	0	0	0	214,114	24,122
Exempt from apportionment	0	734	292	0	34,999	0
Subtotal	50	734	292	0	249,113	24,122
Unobligated balance not available	0	0	0	3	11,060	335
Total Status of Budgetary Resources	**$ 2,141**	**$ 1,408**	**$ 538**	**$ 101**	**$ 742,292**	**$ 29,872**
Relationship Obligations to Outlays						
Obligated balance, net						
Unpaid obligations brought forward	$ 209	$ 152	$ 42	$ 19	$ 57,811	$ 0
Uncollected customer payments Federal sources brought forward	(6)	(4)	0	0	(418)	0
Total unpaid obligated balance, net	203	148	42	19	57,393	0
Obligations incurred, net	2,091	674	246	98	482,119	5,415
Gross Outlays	(2,013)	(660)	(241)	(96)	(482,199)	(5,409)
Recoveries prior year unpaid obligations	(27)	0	(3)	(3)	(413)	0
Change uncollected customer payments	(1)	0	0	0	71	0
Obligated balance net, end of period						
Unpaid obligations	260	166	44	19	57,318	6
Uncollected customer payments federal	(7)	(4)	0	(1)	(347)	0
Total unpaid obligated balance, net	253	162	44	18	56,971	6
Net Outlays						
Gross outlays	2,013	660	241	96	482,199	5,409
Offsetting collections	(2,075)	(740)	(272)	(3)	(8,194)	(335)
Distributed offsetting receipts	0	0	0	0	(16,211)	0
Net Outlays	**$ (62)**	**$ (80)**	**$ (31)**	**$ 93**	**$ 457,794**	**$ 5,074**

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The Department of the Treasury

OTHER ACCOMPANYING INFORMATION

APPENDICES

Appendix A: Other Accompanying Information (Unaudited)

Appendix B: Improper Payments Information Act

Appendix C: Management Challenges and Responses

Appendix D: Material Weaknesses, Audit Follow-up, and Financial Systems

Appendix E: Full Report of the Treasury Department's Fiscal Year 2008 Performance Measures

GLOSSARY OF ACRONYMS

PART IV

TAB A - Department of the Treasury Materials

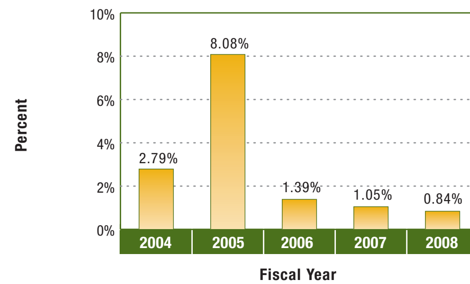
APPENDIX A: OTHER ACCOMPANYING INFORMATION (UNAUDITED)

This section provides Other Accompanying Information as prescribed by OMB Circular A-136, *Financial Reporting Requirements.*

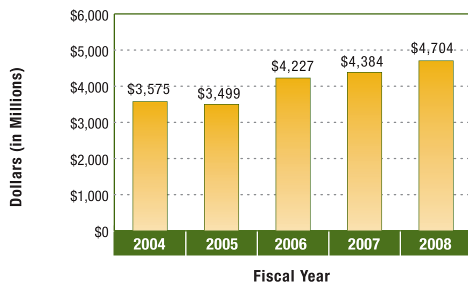
PROMPT PAYMENT

The Prompt Payment Act requires federal agencies to make timely payments to vendors for supplies and services, to pay interest penalties when payments are made after the due date, and to take cash discounts only when they are economically justified. Treasury bureaus report Prompt Payment data on a monthly basis to the Department, and periodic quality control reviews are conducted by the bureaus to identify potential problems.

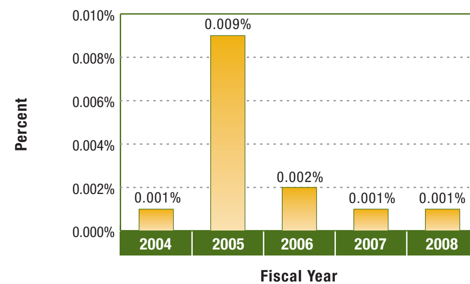
Percentage of Number of Invoices Paid Late



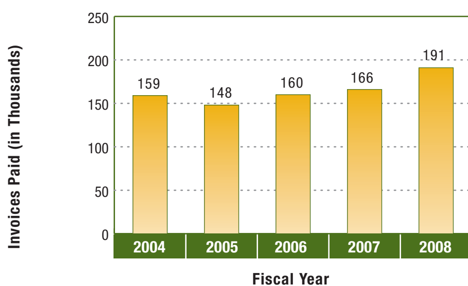
Total Dollar Amount of Invoices Paid (in Millions)



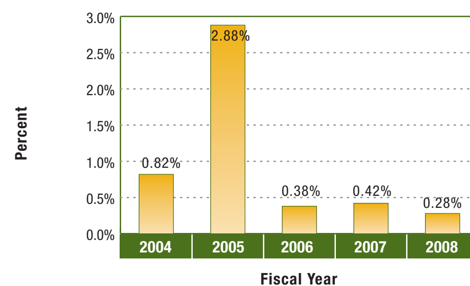
Percentage of Dollar Amount of Interest Penalties Paid



Total Number of Invoices Paid (in Thousands)



Percentage of Number of Interest Penalties Paid



TAX GAP

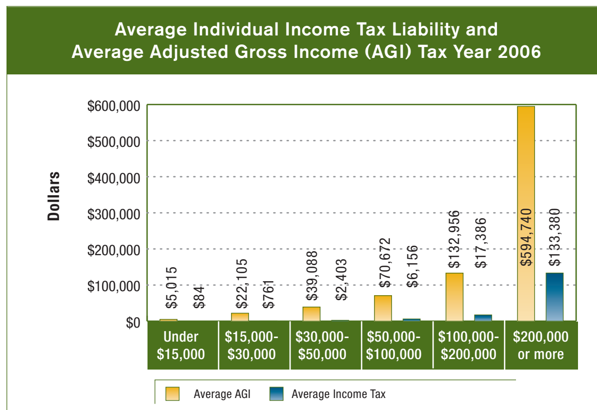
Reducing the tax gap is at the heart of IRS' enforcement programs. The tax gap is the difference between what taxpayers should pay and what they actually pay due to not filing tax returns, not paying their reported tax liability on time, or failing to report their correct tax liability. The tax gap, about $345 billion based on updated estimates for tax year 2001, is the amount of tax that is not paid voluntarily and on time. Underreporting tax liability accounts for 82% of the gap, with the remainder almost evenly divided between nonfiling (8%) and underpaying (10%). The IRS remains committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

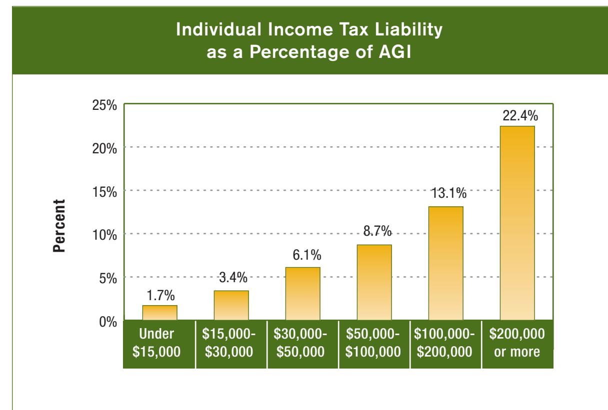
The tax gap is the aggregate amount of tax (i.e., excluding interest and penalties) that is imposed by the tax laws for any given tax year but is not paid voluntarily and timely. The tax gap arises from the three types of noncompliance: not filing required tax returns on time or at all (the nonfiling gap), underreporting the correct amount of tax on timely filed returns (the underreporting gap), and not paying on time the full amount reported on timely filed returns (the underpayment gap). Of these three components, only the underpayment gap is observed; the nonfiling gap and the underreporting gap must be estimated. Each instance of noncompliance by a taxpayer contributes to the tax gap, whether or not the IRS detects it, and whether or not the taxpayer is even aware of the noncompliance. Obviously, some of the tax gap arises from intentional (willful) noncompliance, and some of it arises from unintentional mistakes.

The collection gap is the cumulative amount of tax, penalties, and interest that has been assessed over many years, but has not been paid by a certain point in time, and which the IRS expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the IRS' balance sheet. The tax gap and the collection gap are related and overlapping concepts, but they have significant differences. The collection gap is a cumulative balance sheet concept for a particular point in time, while the tax gap is like an income statement item for a single year. Moreover, the tax gap estimates include all noncompliance, while the collection gap includes only amounts that have been assessed (a small portion of all noncompliance).

TAX BURDEN

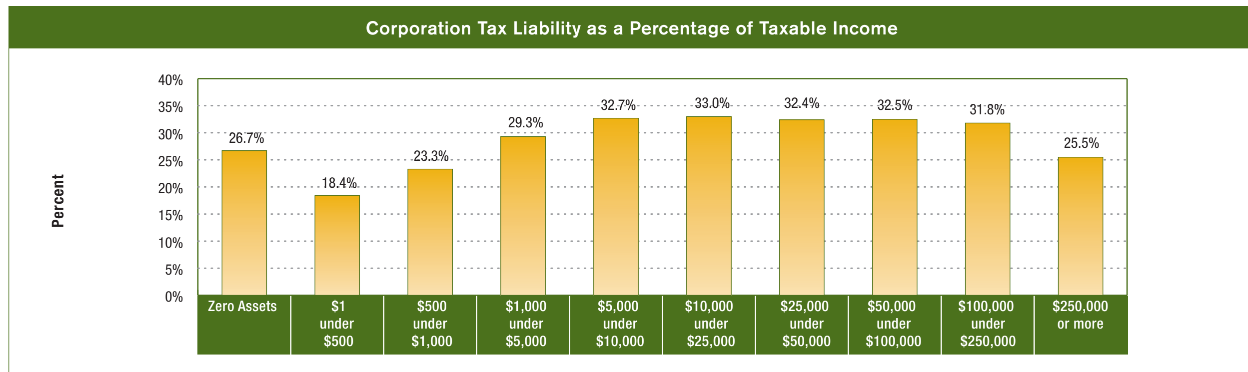
The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The graphs below present the latest available information on income tax and adjusted gross income (AGI) for individuals by AGI level and for corporations by size of assets. For individuals, the information illustrates, in percentage terms, the tax burden borne by varying AGI levels. For corporations, the information illustrates, in percentage terms, the tax burden borne by these entities by various sizes of their total assets. The graphs are only representative of more detailed data and analysis available from the IRS Statistics of Income (SOI) office.





Individual Income Tax Liability Tax Year 2006

Adjusted Gross Income (AGI)	Number of taxable returns (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in whole dollars)	Average income tax per return (in whole dollars)	Income tax as a percentage of AGI
Under $15,000	37,614	188,624	3,141	5,015	84	1.7%
$15,000 under $30,000	29,649	655,386	22,562	22,105	761	3.4%
$30,000 under $50,000	24,907	973,569	59,846	39,088	2,403	6.1%
$50,000 under $100,000	30,053	2,123,894	185,019	70,672	6,156	8.7%
$100,000 under $200,000	12,110	1,610,028	210,538	132,956	17,386	13.1%
$200,000 or more	4,088	2,431,160	545,226	594,740	133,380	22.4%
Total	**138,421**	**$7,982,661**	**1,026,332**			



Corporation Tax Liability Tax Year 2005

Total Assets (in thousands)	Income subject to tax (in millions)	Total income tax after credits (in millions)	Percentage of income tax after credits to taxable income
Zero Assets	19,086	5,094	26.7%
$1 under $500	9,223	1,698	18.4%
$500 under $1,000	4,473	1,043	23.3%
$1,000 under $5,000	14,935	4,372	29.3%
$5,000 under $10,000	9,367	3,060	32.7%
$10,000 under $25,000	13,506	4,456	33.0%
$25,000 under $50,000	13,459	4,366	32.4%
$50,000 under $100,000	14,239	4,624	32.5%
$100,000 under $250,000	31,250	9,935	31.8%
$250,000 or more	1,071,781	273,431	25.5%
Total	**1,201,319**	**312,079**	**26.0%**

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Financial Reporting Position Paper No. 08-04
October 25, 2008

Classification of GSE-related and ESF Money Market Fund Insurance Transactions As Entity or Non-Entity

Conclusion

The transactions arising from the mortgage-backed securities (MBS) purchase program, the Government Sponsored Enterprise (GSE) credit facility, and the Exchange Stabilization Fund (ESF) money market fund insurance program should be reported as "entity" transactions in the Department's financial statements.

The transactions arising from the receipt of the GSE preferred stock and common stock warrants should be reported as "non-entity" transactions in the Department's financial statements. However, the liquidity commitment contained in the preferred stock purchase agreement should be accounted for as an entity liability.

Background

In September of 2008 the Department entered into several new programs to address the liquidity crisis in the mortgage markets and the overall economy. To help address the liquidity problems being experienced by Fannie Mae and Freddie Mac (the GSEs), the Department embarked on a program of buying MBSs in the open market to help stabilize that market. Approximately $3.3 billion of MBSs were purchased in FY 2008. The Department entered into a liquidity agreement with the GSEs which provides for the Department to provide up to $100 billion to each GSE in return for an increase in the Department's investment in GSE preferred stock. The Department received preferred stock with a liquidity preference value of $1 billion from each GSE as a fee for the liquidity agreements. The Department also received warrants to purchase 79.9% of each GSE's common stock as further consideration for entering into the liquidity agreements. Finally, the Department agreed to provide the GSEs with short-term liquidity through an increased credit facility. This credit facility is also available to the Federal Home Loan Banks.

In addition, the ESF was authorized to provide insurance on money market funds of non-FDIC insured institutions to protect the owners of those funds against losses if the funds' net asset values fall below $1. ESF assets of up to $50 billion are available to pay for any covered losses.

The details for each of these new programs are provided in separate FY 2008 financial reporting position papers.

Basis for Conclusion

In determining whether the transactions underlying these new programs should be accounted for as entity or non-entity, the Department looked to SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, notably paragraphs 25 and 43. Paragraph 25 defines non-entity assets as those assets that are held by an entity but are not available to the entity, such as tax receivables. Paragraph 43 defines entity receivables as amounts that a Federal entity claims for payment from other Federal or non-Federal entities that the Federal entity is authorized by law to include in its obligational authority or to offset its expenditures and liabilities upon collection.

SFFAS No. 1, paragraph 26, states that "Both entity and non-entity assets under an entity's custody should be reported in the entity's financial statements. Non-entity assets reported in an entity's financial statements should be segregated from entity assets. An amount equal to non-entity assets should be recognized as a liability (due to Treasury or other entities) in the entity's financial statements."

In a letter dated August 24, 1998, Norwood Jackson, OMB Deputy Controller, concurred that Treasury government-wide activity should not affect the net position of the Treasury operating entity. The Department recognizes a liability, "Due to the General Fund," as an amount equal to non-entity assets that are held for the government as a whole. Conversely, the Department recognizes an asset, "Due from the General Fund," as an amount equal to the funding needed to offset liabilities that are incurred for the government as a whole (e.g., Federal Debt).

MBS Purchase Program

The MBS purchase program is a Credit Reform Act program administered by the Department. As such, funds for the purchases are borrowed from the Bureau of Public Debt, and interest accrues on those borrowings. Proceeds from the eventual sale of MBSs, which are classified as loans receivable per credit reform accounting, will be used to repay BPD for the principal and interest. Thus the Department will use the collections on the MBSs to offset its liabilities and pay the interest expenses on its loans from BPD. Accordingly, the loans receivable meet the paragraph 43 definition of entity receivables. All related transactions will also be accounted for as entity transactions.

GSE Credit Facility

No loans were provided to the GSEs under the credit facility agreements in FY 2008. In future years, any credit facility loans will be accounted for under the Federal Credit Reform Act in the same manner as the MBS purchase program. Thus any future credit facility loans receivable will also be accounted for as entity assets, as will any related transactions.

ESF Money Market Fund Insurance

ESF collects the premiums for this program and retains those premiums to satisfy any future claims. Claims that are in excess of premiums collected will be paid from the assets of ESF. Paragraph 43 of SFFAC No. 1 thus applies to this program as well, and all related transactions will be accounted for as entity transactions.

The Emergency Economic Stabilization Act of 2008, Section 131, enacted on October 3, 2008 protects ESF from incurring any losses due to this temporary money market mutual fund guarantee by requiring the Secretary of the Treasury, through the Department's Office of Financial Stability (OFS), to reimburse ESF. Further, it prohibits any future use of ESF for any guarantee program for the money market mutual fund industry. No claims were filed and ESF did not pay any claims in FY 2008. If there are any claims paid by ESF in FY 2009, ESF will be reimbursed by OFS.

GSE Preferred Stock/Warrants

The Department holds the preferred stock and common stock warrants on behalf of the Federal Government – it cannot use any proceeds from future sales of stock to pay its liabilities or expenses. Sales proceeds will not give rise to obligational authority. The same will hold true for any future increases in the value of the preferred stock resulting from cash infusions to the GSEs. The preferred stock and common stock warrants are therefore non-entity assets, and will be offset with "Due to the General Fund" liabilities.

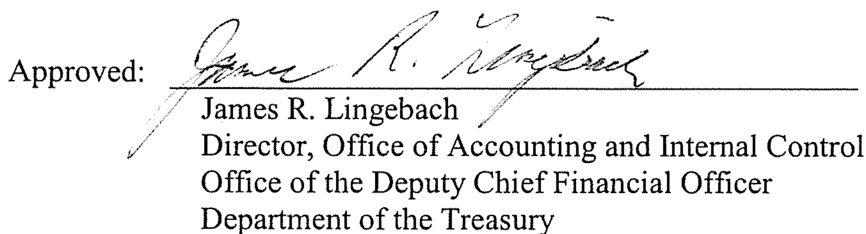
GSE Liquidity Guarantee

The Department has engaged an independent contractor to determine if there is an estimable future liability to the GSEs pursuant to the $200 billion liquidity guarantee. If such a liability exists, is reasonably estimable, and is considered more likely than not to be paid in the future, we may record a contingent liability for the discounted present value of the liability. As the Department has received an appropriation of funds to make any future liquidity payments, and these appropriated funds are part of the Department's Fund Balance with Treasury, the Department is not dependent on additional external resources to pay any liquidity liability that may arise. Accordingly, if a liability is recorded for the liquidity guarantee it will be classified as an entity liability. The offset to any liability would be a "deferred asset" account.

If the quarterly analyses of the GSEs' assets and liabilities result in liquidity payments under this agreement, the contingent liability will be debited and FBWT credited. At the same time, the preferred stock account will be debited with an offsetting credit to the "deferred asset" account. ***(Note: It may make more sense to just make footnote disclosure of possible liability, rather than set up the "deferred asset" account.)***

The Financial Management Service has issued the following Departmental (DO) Treasury fund symbols for reporting the GSE transactions.

Fund Symbol	Title	Entity/Non-Entity	Comment
202790.1	GSE Mortgage Backed Securities Direct Loans, Negative Subsidy	Non-entity	General Fund Receipt Account – FY 08 transactions
202791.1	GSE Credit Facility, Negative Subsidy	Non-entity	General Fund Receipt Account - **No FY 08 transactions –credit line**
202894	Proceeds, GSE Equity Related Transactions	Non-entity	General Fund Receipt Account – GSE preferred stock and warrants & associated revenue.
208/00126	GSE MBS Purchase Program Account	Entity	No material FY 08 transactions
208/00127	GSE Credit Facility Program Account	Entity	**No FY 08 transactions- credit line**
2008/125	Assist to FNMA and FHLMC	Entity	**No FY 08 transactions –liquidity**
2090126	GSE MBS Purchase Program Account	Entity	**No FY 08 transactions (2009 fund symbol)**
20X4272	MBS Direct Loan Financing Account	Entity	FY 08 transactions – MBS recorded in this account
20X4273	GSE Credit Facility Direct Loan Financing Account	Entity	**FY 08 transactions**

Approved: 

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Financial Reporting Position Paper No. 08-01
October 19, 2008

Consideration of Consolidating Fannie Mae and Freddie Mac In FY 2008 Department of the Treasury Financial Statements

Conclusion

Fannie Mae and Freddie Mac should not be consolidated into the Department of the Treasury's (Department/Treasury) or the Federal government's financial statements. As discussed below, FASAB provides the authoritative guidance by which such a determination should be made. While not within the Department's purview, we believe this conclusion also applies to the Federal Housing Finance Agency (FHFA).

Background

Three separate sections of Statement of Federal Financial Accounting Concept (SFFAC) No. 2 are relevant to the question of whether to include Fannie and Freddie in a Federal entity (e.g., FHFA or Treasury) for financial reporting purposes.

First, in paragraphs 41 and 42, SFFAC No. 2 states that any organization that appears in the Federal budget section currently entitled "Federal Programs by Agency and Account" must be included in some Federal entity's financial statements (and ultimately in the Government's consolidated financial statements). If an organization is not listed in the "Federal Programs by Agency and Account," then paragraphs 43 and 44 of SFFAC No. 2 specify that the following criteria, in descending order of importance, must be considered to determine whether to include the organization in a Federal reporting entity:

- Whether the organization exercises any sovereign power of the government to carry out Federal functions;
- Whether the organization is owned by the Federal Government;
- Whether the organization is subject to the direct or continuing administrative control of the reporting entity;
- Whether the organization carries out Federal missions and objectives;
- Whether the organization determines the outcome or disposition of matters affecting the recipients of services that the Federal Government provides; and
- Whether the organization has a fiduciary relationship with a reporting entity.

No single criterion is conclusive in determining whether to include the organization in a reporting entity; rather, all of the criteria are to be considered together in making the determination. The existence of one or more of the above criteria would indicate the need to further evaluate whether the organization should be consolidated.

Further, paragraph 45 of SFFAC No. 2 requires consideration of whether any of the above criteria, if they apply, are likely to remain in existence for a time (i.e., the interest in the entity and its governmental characteristics is more than fleeting). As discussed later in this paper, we conclude that none of the first five criteria apply to this situation. A type of fiduciary relationship does exist between Treasury and the GSEs. And, while the expanded credit facility agreement expires at the end of December, 2009, the preferred stock purchase agreement has no set expiration date and the common stock warrants do not expire until September 2028. Thus, this fiduciary relationship is "more than fleeting." However, as discussed in the next to last paragraph of this paper, the existence of this fiduciary relationship does not indicate control and thus does not lead to any indication that the GSEs should be included in Treasury's financial statements.

Second, in paragraphs 48 and 49, SFFAC No. 2 provides guidance regarding Government Sponsored Enterprises (GSEs) such as Fannie and Freddie, stating in paragraph 48:

> By law, each of these GSEs is subject to oversight from a specific Federal agency. However, they are not included in the Federal budget section entitled "Federal Programs by Agency and Account." Nor, as currently constituted, do they function in a manner consistent with the indicative criteria presented in paragraph 44 [in bullet points above]. Thus **<u>they would not be considered part of the government-wide reporting entity nor the reporting entity to which they have been assigned for oversight</u>**. (emphasis added)

As discussed below this fundamental relationship has not been altered by recent developments.

Paragraph 49 of SFFAC No.2 goes on to say that:

> "On the other hand, there are 'political expectations' associated with the GSEs, the most significant of which is an expectation that legislation would be enacted to support a GSE experiencing severe financial difficulties. ... Therefore, agencies assigned oversight responsibility for a GSE(s) would need to consider making disclosures of the government's relationship with the GSE(s) and other information that would provide an understanding of the possibility of a contingent liability."

The Housing and Economic Recovery Act of 2008 provided the Department with authorities to provide financial support to Fannie Mae and Freddie Mac to address the GSEs' "severe financial difficulties" and the overall need to improve the situation in the mortgage market. It also created the FHFA as the new oversight agency for the GSEs, with expanded oversight authority over its predecessor oversight agency. This legislation, and the Department's exercising of its related

authorities, in part responded to the "political expectations associated with the GSEs." As with the discussion of paragraph 48 above, these actions did not alter the fundamental relationship between the government and the GSEs. While the Department is not the oversight agency for the GSEs, it is making extensive disclosures of its relationship with the GSEs. These disclosures are discussed in detail in other FY 2008 financial reporting position papers.

Basis for Conclusion

As is always the case in Federal Government accounting, FASAB guidance is the appropriate source of GAAP, unless FASAB guidance does not address the situation under consideration. FASAB SFFAC No. 2 clearly provides guidance on whether to include Fannie Mae and Freddie Mac as discussed above.

As GSEs, Fannie Mae and Freddie Mac have not previously been (nor will they be under the new conservatorship) part of the Federal budget and therefore do not meet the criterion for inclusion in a Federal reporting entity specified in SFFAC No. 2 paragraphs 41 and 42.

Consideration of the six criteria in SFFAC No. 2 paragraphs 43 and 44 also leads to the conclusion that that Fannie Mae and Freddie Mac should not be included in a Federal reporting entity, as only the last, and lowest priority, criteria is applicable to the relationship of the Federal Government to the GSEs.

Five of the criteria are not applicable to Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac do not exercise sovereign power and are not owned by the Federal Government. The warrants that the Government has acquired have not been exercised. The warrants themselves do not represent nor are they equivalent to ownership because a warrant represents the right to purchase stock at some future date at a predetermined price and not the purchase of stock itself. Thus the GSEs are not owned by the Federal Government. While the FHFA in its conservatorship role exercises administrative control over the GSEs, and the Secretary of the Treasury is a member of the FHFA Oversight Board, a conservatorship by its nature is intended to be of relatively short-term duration and is not construed to constitute ownership. While the GSEs were established by Congress to further Federal Government objectives, they are chartered as publicly owned companies and therefore are not directly carrying out Federal missions or objectives. And, the GSEs are not involved in determining outcomes or disposing of matters affecting recipients of Federal Government services.

For the last, lowest priority criterion, it can be argued that the Federal Government does have a fiduciary relationship with the GSEs arising from the FHFA conservatorship role and the Department's liquidity and credit facility arrangements. However, as described in the relevant SFFAC No. 2 paragraphs quoted above, this type of fiduciary relationship does not result in an ownership type of relationship. Further, these types of fiduciary relationships are fairly common in the Federal Government environment, in view of the Federal Government's role, and such a relationship is not deemed in any way to create ownership interests. The same holds true for the current Departmental and Federal Government relationship with the GSEs.

The third relevant section of SFFAC No. 2 is paragraph 50, which provides guidance for "bailout entities" as follows:

> The Federal Government occasionally bails out, i.e., guarantees or pays debt, for a privately owned entity whose failure could have an adverse impact on the nation's economy, commerce, national security, etc. As a condition of the bail out, the Federal Government frequently obtains rights similar to the authorities associated with the indicative criteria presented in paragraph 44 [in bullet points above]. **The existence of these rights does not make the bailed out entity part of the Federal Government reporting entity or any of the other reporting entities that are part of the Federal Government. Disclosure of the relationship(s) with the bailed out entity (ies) and any actual or potential material costs or liabilities would be appropriate.** (emphasis added)

The GSEs are not really "bailout entities" as the agreements entered into with the GSEs do not directly guarantee or pay their debts. However, the agreements do provide the GSEs with additional capital as needed, through the preferred stock purchase agreement and the expanded credit facility agreement. This additional capital can then be used to pay GSE expenses and debts, which can help them avoid entering into receivership while they are resolving their financial problems. By applying paragraph 50, one arrives at the same conclusion – that the GSEs are not part of the Federal Government and should not be consolidated with any Federal entity for financial reporting purposes.

The recent actions taken to stabilize Fannie Mae and Freddie Mac are intended to help them return to normal operations. The Senior Preferred Stock agreement indicates that upon exercise of the common stock warrants (in whole or part), the Treasury may assign its right to receive the common stock shares to another party, which would suggest that the Government's interest is not permanent. One purpose of obtaining the warrants is to preclude speculation in GSE common stock while they are in conservatorship and in the period when they are no longer in conservatorship. Another purpose is to help minimize the cost to taxpayers if the warrants can be exercised/sold at a profit in the future. There is no plan to bring these organizations into the government; rather, the purpose of these financial arrangements is to place the GSEs in a sound and solvent position so they can emerge from conservatorship as viable going concerns.

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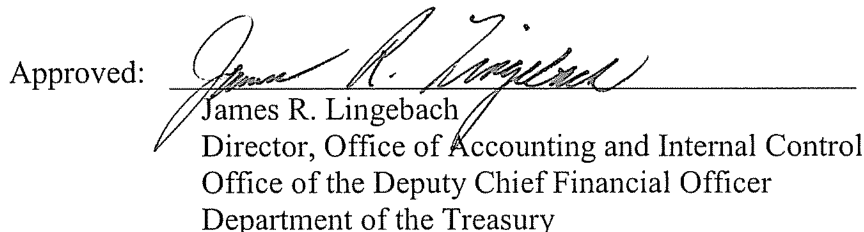

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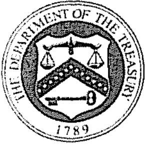

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Financial Reporting Position Paper No. 08-02
October 18, 2008

Treatment of Purchases of Mortgage-Backed Securities and Credit Facility

Conclusion

The purchase of Fannie Mae and Freddie Mac mortgage-backed securities (MBS) and the credit facility for the GSEs are credit reform transactions, subject to the budgetary and proprietary accounting requirements of the Federal Credit Reform Act of 1990, as amended (FCRA), Statement of Federal Financial Accounting Standard (SFFAS) No. 2, Circular No. A-11, and Circular No. A-136.

Background and Basis for Conclusions

Both activities clearly fall within the FCRA definition of a direct loan, (2USC661a), which is reiterated in section 185.3(d) of Circular A-11. FCRA states:

(1) The term "direct loan" means a disbursement of funds by the Government to a non-Federal borrower under a contract that requires the repayment of such funds with or without interest. The term includes the purchase of, or participation in, a loan made by another lender and financing arrangements that defer payment for more than 90 days, including the sale of a government asset on credit terms.

Treasury Purchase of Mortgage Backed Securities

The critical determinant of budgetary treatment is the economic substance of the transaction. In the case of purchasing MBS, there are two areas of OMB Circular A-11 guidance that appear to be applicable: Section 113, which provides guidance on agency investments, and Section 185, which provides guidance on budget formulation and execution of credit programs.

On its face, Section 113 of Circular A-11, which provides guidance on investments, seems to apply, because investments include the purchase of debt instruments. Generally, agencies with investment authority use funds to make an investment, with an expectation of future return, to finance future programmatic activities. The nature of Treasury's purchases of MBS, however, is substantively different. The purchases are not intended to finance agency activities, or necessarily generate a profit, but instead to support the market. Such a purpose indicates that treatment as a credit program might be more appropriate.

Section 185 of Circular A-11 provides guidance for credit programs. The FCRA applies to all direct loans obligated and loan guarantee commitments made after 1991. Therefore, all programs which enter into transactions meeting the definition of a direct loan or a loan guarantee are treated as subject to the FCRA, whether or not Congress explicitly subjects those programs to the FCRA in the authorizing legislation. For example, the Telecommunications Act of 1996, which permitted private firms to pay the Federal Communications Commission for spectrum licenses over a 10-year period, did not reference the FCRA. However, in substance, the transaction was effectively a form of seller financing, with the Government making a direct loan to the firm to purchase the asset and receiving repayments from the purchaser over time. The program is reflected in the FCC's budget and financial statements as subject to FCRA.

Similarly, Treasury's authority to purchase MBS provided by the Housing and Economic Recovery Act of 2008 did not explicitly reference the FCRA. However, the purchase – a purchase of the right to a stream of principal and interest payments – meets the FCRA definition of a direct loan as a "purchase of or participation in a loan made by another lender." Furthermore, as described above, the intent of the activity is to increase liquidity and support the MBS market, regardless of whether the cost to the Government is positive, negative, or zero.

In purchasing the MBS, Treasury is essentially stepping into the role of the lender, and has a right to the future principal and interest streams of the underlying mortgages. There is a greater degree of separation between the Government and the borrowers by purchasing the MBS on the open market, rather than purchasing the underlying mortgage. Still yet in purchasing the MBS, the Government has essentially become the lender on the underlying mortgages. In economic substance, the activity is a disbursement from the Government, repaid over time with interest.[1] Therefore, the application of Circular A-11 Section 185, treating the MBS purchases as a credit program and subject to the provisions of the FCRA, is more appropriate.

Congress has recognized this distinction in the proposed legislation that creates the Troubled Asset Relief Program (TARP), which establishes a substantially similar, but larger MBS purchase program within the Department of the Treasury. (See Emergency Economic Stabilization Act of 2008, Section 123). Provisions in the TARP require these transactions be accounted for as a loan receivable under FCRA[2]. From a practical standpoint, if the MBS purchased in association with Fannie Mae and Freddie Mac are not accounted for under FCRA we will have two substantially similar programs that will be treated differently in the financial statements.

While Financial Accounting Standards Board (FASB) Statement No. 115 has been referenced as support for investment treatment of MBS purchases, this would be inconsistent with the Financial Accounting Standards Advisory Board's (FASAB) intent under SFFAS No. 2 paragraph 17, which states that the accounting treatment of direct loans and loan guarantees

[1] The 1967 Report of the President's Commission on Budget Concepts established a comprehensive conceptual framework for the federal budget According to the commission, the budgetary treatment of a transaction should depend on its economic substance.

2 It has come to our attention that there are questions regarding the statement in the TARP that FCRA should be used "if applicable." This statement was included in case other transactions, such as swaps, were included. It does not apply to the purchase of MBS, which would be accounted for under FCRA. See also letter from CBO Director Orszag to Representative Frank where CBO concludes MBS purchases under the proposed TARP program should be accounted for under FCRA.

should be consistent with the budgetary treatment. In the Federal hierarchy FASAB Statements take precedent over FASB literature. FASAB guidance is the appropriate source of Generally Accepted Accounting Principle (GAAP) to follow in this situation.

However, accounting for the MBS under credit reform rather than as an investment would **not** have a material impact to the bottom line of the financial statements. As such, the preparer should have discretion to choose the presentation for the financial statements.

Initial Valuation: The valuation of the MBS as an investment or as a loan receivable under credit reform will not be substantially different. Under credit reform the instruments will be calculated using a net present value technique which would include relevant risk factors based on market condition. As an investment, although we have the ability to hold the MBS to maturity, we would not meet the intent criteria in FASB statement No. 115 in order to consider the MBS as held-to-maturity securities. Changes in market conditions over time would be evaluated and could result in sales of the MBS. As such, the MBS would be recognized at fair market value (FMV). The distressed nature of the market and the lack of liquidity in the market would necessitate FMV be based on unobservable inputs per FASB Statement No. 157, that permits the use of estimation techniques to include discounted cash flow analysis. In this scenario it is reasonable to assume the discounted cash flow net present value technique used in credit reform would be the best technique to use to estimate FMV.

Subsequent Recognition: The subsequent recognition of the MBS as an investment that is not held-to-maturity or as a loan receivable under credit reform would continue to be substantially the same in a distressed market. FASB Statement No. 115 would require the MBS to continue to be marked to market. Again, FASB Statement No. 157 would permit using a discounted cash flow analysis such as the net present value under credit reform. It is possible that in the long run variations between the two treatments would be created, however we currently do not know if a significant gap will exist. We do know that the present value technique under credit reform does consider market indicators but at this time we are not able to determine if differences will result in the long run. However, we expect that the market will be distressed for some time.

Presentation: The MBS would be better presented as a loan receivable subject to the credit reform act than as an investment. The purchase of the MBS is not a mechanism for generating profit for the Government, but rather a means to support the market by increasing liquidity and housing affordability. This responsibility to support the market will determine how the assets are bought, sold, and managed. Once purchased, the Government has a stewardship responsibility to then manage these illiquid assets in a manner that protects taxpayer interest. Presenting the MBS transactions as an investment instead of a loan in the financial statement would distort the fair presentation of those statements. Both FASAB and FASB GAAP recognize the importance of recognizing the economic reality of transactions over the legal form for fair presentation[3]. If the purchase of the MBS were presented as an investment the intent and this stewardship responsibility would not be transparent in the financial statements.

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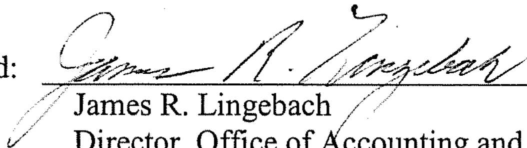
[3] FASAB SFFAS 31 paragraph 46 states, "The Board believes that the substance of a transaction, rather than its form, should be the determining factor in how it is reported." FASB Statement of Concept No. 2 provides that "requirements for representational faithfulness leaves no room for accounting representations that subordinate substance over form."

Credit Facility

Treasury may also provide short-term loans to the GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks). While the lending provided under this facility is anticipated to be short-term loans to the GSEs, such transactions are clearly credit reform, as there is a disbursement of funds by the Government that require repayment over time with interest. 2 USC 661a(5) defines the "cost" of direct loans and loan guarantees, referring to the "long term cost to government." This definition does not rest on the maturity of the direct loan or loan guarantee; rather, it looks to the potential for cashflows to and from the government over the life of the loan or loan guarantee. This can be far longer than the initial maturity, particularly if there is a modification or default. For example, the credit liquidity facility is backed by MBS; in the event of a GSE default, the recoveries on default through the MBS would last far beyond the original maturity date of the loan.

Approved: 

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Financial Reporting Position Paper No. 08-05
November 17, 2008
Exchange Stabilization Fund (ESF) Money Market Fund Insurance Transactions

Conclusion

The premiums received in FY 2008 will be recognized as revenue over the life of the coverage provided. Thus a small portion of the premiums will be recognized as revenue for FY 2008, with the balance being deferred revenue which will be recognized as revenue in DY 2009. There have been no claims filed with ESF, and no known insurable events have occurred through November 17, 2008. Accordingly there is no need to record a liability for existing unpaid claims or "insured but not recorded" situations.

The Department will make a determination as to whether it is probable that future events during the period of coverage (through December 18, 2008) will give rise to insurable events and, if measurable, record an estimated expense and corresponding liability for such insurable events.

Details of the program will be provided in the footnotes to the financial statements.

Basis for Conclusions

In determining the accounting treatment and financial statement disclosure requirements for transactions underlying this new ESF program, the Department looked to SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, notably paragraphs 97 through 109. (This standard treats insurance and guarantee programs in the same manner, so the terms may be used interchangeably below.) The Department used SFFAS No.1, *Accounting for Selected Assets and Liabilities* as the basis for revenue recognition.

In Statement of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government* (SFFAS No. 5, par 97 -121), the Federal Accounting Standards Advisory Board (FASAB) prescribes accounting for federal insurance and guarantee programs that provide protection to individuals or entities against specific risks.

In SFFAC No. 5, par 98-99, notes that in the private sector insurance contracts are customarily divided into two types:

- **Fixed period** – insurance is provided for a fixed period of time. The insurer may cancel the coverage or adjust the provisions of the coverage at the end of the period.
- **Insurer cannot cancel or insured is guaranteed the ability to renew it** - The insurer must provide coverage for an extended period until the insured event occurs or can no longer occur, or when the insured party allows the coverage to lapse.

The money market insurance offered by ESF appears to conform to the FASAB classification of fixed period, as it has a specified duration of three months with the insurer option of renewing for an additional three months, with payment of another premium by the insured. The maximum duration of the insurance program is one year and does not guarantee the insured with an ability to renew.

According to SFFAS No. 5 ¶ 103-104, a guarantee should be recognized on similar terms as Federal credit programs, in which the Federal government is committed at the time the guarantee is extended to bearing the losses inherent in the terms and conditions. To this end, as stated in SFFAS No. 5 ¶ 109, an expense and corresponding liability should be recognized for events that have occurred in the past and insured events that are likely to occur in the future that are probable and measurable.

SFFAS No. 5, par 104, requires the recognition of liabilities for unpaid claims incurred resulting from insured events that have occurred as of the reporting date (liabilities that are known with certainty). While the ESF insurance program collected premiums prior to and after September 30, 2008, all participant policies were in force as of September 19, 2008. However, no claims had been filed to date, and no known insurable events had occurred as of September 30, 2008 (or subsequently for disclosure purposes). Accordingly, ESF did not recognize any liabilities for unpaid claims at September 30, 2008.

SFFAS No. 5, Paragraph 104, also requires accrual of a contingent liability when an existing condition, situation, or set of circumstances involving uncertainty as to possible loss exists and the uncertainty will ultimately be resolved when one or more probable future events occur or fail to occur; a future outflow or other sacrifice of resources is probable; and the future outflow or sacrifice of resources is measurable. As no claims have been filed or are expected to be filed, the Department determined that there is no contingent liability as of September 30, 2008.

While SFFAS No. 5 is silent on premium revenue recognition, SFFAS No. 1, *Accounting for Selected Assets and Liabilities,* par 85, states the following:

"Federal entities may receive advances and prepayments from other entities for goods to be delivered or services to be performed. Before revenues are earned, the current portion of the advances and prepayments should be recorded as other current liabilities. After the revenue is earned (goods or services are delivered, or performance progress is made according to engineering evaluations), the entity should record the appropriate amount as a revenue or financing source and should reduce the liability accordingly"

Accordingly, ESF recognized revenue for premium payments received that applied to FY 2008 coverage, and recorded prepayments for premium payments applicable to coverage in FY 2009. ESF will recognize additional revenue as coverage is provided in FY 2009.

Background

The Exchange Stabilization Fund (ESF) was established by the Gold Reserve Act of 1934. This Act authorizes the Secretary of the Treasury, with the approval of the President, "to deal in gold, foreign exchange, and other instruments of credit and securities" consistent with the obligations of the U.S. government in the International Monetary Fund to promote international financial stability. For financial statement reporting purposes, it is included as a component of the Departmental Offices (DO). In the Treasury Information Executive Repository (TIER), it is a designated reporting entity with the abbreviated title of ESF (partner code 2041).

On September 19, 2008, the Treasury Department announced the establishment of a temporary guaranty program for the U.S. money market mutual fund industry. For the next year, the Treasury Department will insure the holdings of any publicly offered eligible money market mutual fund – both retail and institutional – that pays a fee to participate in the program.

President George W. Bush approved the use of existing authorities by Secretary Henry M. Paulson, Jr. to make available as necessary the assets of the Exchange Stabilization Fund for up to $50 billion to guarantee the payment in the circumstances described below.

Money market funds play an important role as a savings and investment vehicle for many Americans; they are also a fundamental source of financing for our capital markets and financial institutions. Maintaining confidence in the money market fund industry is critical to protecting the integrity and stability of the global financial system.

Concerns about the net asset value of money market funds falling below $1 have exacerbated global financial market turmoil and caused severe liquidity strains in world markets. In turn, these pressures have caused a spike in some short term interest and funding rates, and significantly heightened volatility in exchange markets. Absent the provision of such financing, there is a substantial risk of further heightened global instability.

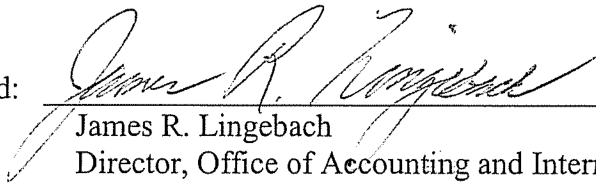
Maintenance of the standard $1 net asset value for money market mutual funds is important to investors. If the net asset value for a fund falls below $1, this undermines investor confidence. The program provides support to investors in funds that participate in the program and those funds will not "break the buck".

This action is intended to enhance market confidence and alleviate investors' concerns about the ability for money market mutual funds to absorb a loss.

More information on the Exchange Stabilization Fund can be found at:

http://www.ustreas.gov/offices/international-affairs/esf/

The Economic Stabilization Act of 2008, Section 131, enacted in October 3, protects ESF from incurring any loses due to this temporary money market mutual fund guarantee by requiring the Secretary of the Treasury, through the Office of Financial Stability, to reimburse ESF. Further, it prohibits any future use of ESF for any guarantee program for the money market mutual fund industry.

Approved: 

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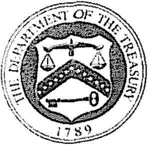

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Financial Reporting Position Paper No. 08-03
November 11, 2008

Accounting for Senior Preferred Stock Purchase Agreement

Conclusions

The senior preferred stock and common stock warrants received in consideration of the Department's entering into the preferred stock agreement should be accounted for as long term non-entity investments. They will be reported at cost (i.e., estimated fair value at date of receipt), with fair values disclosed in the footnotes. Periodic assessment will be made to ascertain if there is any permanent impairment of value.

The fair value at the date of receipt of the preferred stock and warrants will be recorded as a commitment fee that will flow through to the government wide statements but will not affect the Department's net position, as this is viewed as a "non entity" transaction. As the commitment does not have an expiration date, and there is provision for an annual commitment fee to be paid by the GSEs, this fee need not be amortized over future years.

Quarterly payments to GSEs due to their liabilities exceeding their assets will be treated as entity expenses. Expenses/liabilities will be accrued for unpaid liquidity draws that are determined after the close of an accounting period but before the issuance of the financial statements. Increases in the preferred stock liquidity preference resulting from any quarterly payments will also be treated as increases in the long term non-entity investment, with a corresponding increase to "Due to the General Fund." If necessary, a valuation account will be established to record any permanent impairment to the investments (preferred stock or warrants).

The commitment to the GSEs should be valued at its discounted present value based on estimated future cash flows, and recorded as a liability on the Department's financial statements if the amount can be measured with sufficient reliability. If a reliable estimate cannot be made, the amount of the remaining commitment will be disclosed in the notes to the financial statements.

Background and Basis for Conclusions

In September of FY 2008, the Department of the Treasury (Treasury) entered into identical agreements with Fannie Mae and Freddie Mac (GSEs) whereby Treasury would increase the amounts invested in the GSEs' senior preferred stock if the GSEs' liabilities exceeded their

assets, as determined on a quarterly basis by the conservator, the Federal Housing Finance Agency. In exchange for this agreement, each GSE provided Treasury with one million shares in senior liquidation preference non-voting preferred stock having a stated value of $1 billion for each GSE and warrants that allow Treasury to purchase up to 79.9% of the GSE's common stock. The maximum amounts of these commitments are $100 billion per GSE.

This position paper covers the Senior Preferred Stock Purchase Agreement (Agreement) described above and specifically addresses (1) the appropriate accounting categorization for the senior preferred stock, common stock warrants, and Treasury's fiscal exposure incurred as a result of the "Commitment" provisions beginning on page 4 of the Agreements; (2) the appropriate Generally Accepted Accounting Principles (GAAP) to be applied; (3) the measurement methodology; and (4) the mechanics of the account.

Accounting Categorization

Preferred Stock and Common Stock Warrants -

The preferred stock and common stock warrants were received from the GSEs in consideration of Treasury making the commitment to increase the liquidity value of Treasury's preferred stock by up to $100 billion for each GSE if GSE liabilities exceed assets at the end of any quarter. The preferred stock has the normal terms and conditions of preferred stock, and has a stipulated dividend rate. There is no provision for repayment, except under limited conditions involving the GSEs issuing additional stock, which the GSEs are not required to do. Accordingly, the preferred stock is considered to be a long term investment, and should be accounted for accordingly. The common stock warrants were received as part of the same transaction, so accounting for them should follow the accounting for the preferred stock.

FASAB standards do not specifically address these types of investments in non-governmental securities. However, SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, does provide guidance for accounting for investments held to maturity. The preferred stock has no maturity date, and the warrants expire in 2028. For both the stock and warrants, the intent is to hold them for an extended period of time, so for all intents and purposes they can be considered as being "held to maturity." Accordingly, both the stock and the warrants should be carried at cost (i.e., estimated fair value at date of receipt), with footnote disclosure of fair values at subsequent balance sheet dates, absent any permanent impairment of values. (There is no discount or premium involved.)

It should likewise be noted that, even for investments not held to maturity, the Treasury Financial Manual states its guidance is needed only for those few Federal entities required to report investments at fair value in their audited financial statements. The TFM further states that these entities are limited to those 'required by law or policy to publish financial statements pursuant to FASB....' (which the Department is not).While the TFM is not part of the GAAP hierarchy, it does provide relevant guidance for consideration by Federal agencies.

Commitment Fee –

The preferred stock and warrants were received in consideration for the extension of the liquidity guarantee. The liquidity guarantee is somewhat like an insurance policy for the GSEs, insuring against the potential excess of liabilities over assets, so the fee is similar to an insurance

premium. Commitment fees or insurance premiums are normally recognized as revenues over the life of the commitment or policy. In this case the commitment period is indefinite in that it has no expiration date, so there is no set period over which to recognize the revenue. Coupled with the fact that the liquidity agreements provide for additional annual fees beginning in 2010, we decided to recognize the entire fee as revenue for FY 2008.

Liquidity Commitment -

A basic concept for fair presentation in accounting is the need to categorize transactions to best capture the economic reality of the event or transaction being recorded. The Federal Accounting Standards Advisory Board (FASAB) recognizes the importance of this concept for fair presentation when discussing the need to present reliable and relevant information.[1]

Keeping this concept in mind, we evaluated the Agreement for the appropriate accounting treatment; considering several options, including loan and investment treatment. In many respects, the Agreement has characteristics of an investment with a commitment to purchase the GSEs senior preferred stock. However, the reason for providing this commitment is to infuse capital into the GSEs if their liabilities exceed their assets. This intent changes the form of the Agreement for accounting purposes to reflect a guarantee type arrangement rather than an investment.

A key feature of direct loans is the requirement that the borrower repay the loan principal. The agreements Treasury entered into with the two GSEs does not require the GSEs to repurchase their preferred stock. Furthermore, this agreement lacks traditional elements found in loan arrangements such as collateral and maturity dates. In addition, the Federal Credit Reform Act (FCRA) definition of a direct loan means the disbursement of funds by the Government under a contract that requires repayment with or without interest, including the purchase of, or participation in, a loan made by another lender. In this Agreement, unlike the MBS program, Treasury is not participating in a loan made by another lender and there is no requirement for repayment. As such, we concluded this would not be a direct loan or loan guarantee under the FCRA.

Due to the characteristics of the "Commitment," the guaranty category provides the fairest presentation. We considered accounting for the Agreement as a guarantee under SFFAS Standard No. 2, which provides guidance on loans and loan guarantees and found this would not be the appropriate standard to apply. A key feature of loan guarantee is the existence of debt. In this situation there are no repayment requirements, no maturity date, and no underlying collateral. And, there is no third party to whom any direct payments will be made if cash infusions are required. For these reasons we conclude that we are not guaranteeing a debt. This led us to SFFAS Standard No. 5, which provides guidance for liabilities, commitments, and guarantees for Federal entities.

Appropriate GAAP Standard

FASAB, the Federal accounting guidance, is the appropriate source of GAAP for Treasury, a Federal agency, to follow. It has also been an objective of FASAB to ensure uniform application

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[1] Statement of Federal Financial Accounting Concept (SFFAC) No. 1. In addition the Board's intent was reinforced in FASAB Statement of Federal Financial Accounting Standards (SFFAS) 31 where paragraph 46 states, "The Board believes that the substance of a transaction, rather than its form, should be the determining factor in how it is reported."

of its standards as much as practical. The FASB has even recognized this objective by indicating that FASAB not FASB sets Federal GAAP. [2]

This situation presents a very visible opportunity for FASAB GAAP to demonstrate rigorously the applicability, relevance, and usefulness of its hierarchy given its relatively new GAAP status that the AICPA conferred on it in 1999. And, we need to avoid unnecessary complications in the accounting for the new and complex role the Treasury is playing in the U.S. financial markets and to ensure that FASB standards are used only when there is a compelling justification. Not only is FASAB GAAP the proper framework for selecting the principles used in the preparation of Federal entities' financial statements that are presented in conformity with United States GAAP, FASAB Statements take precedence over FASB literature. To this end, FASAB's SFFAS Standard No. 5 clearly provides guidance for the treatment of the Commitments as guarantees.

First, "guarantees" are within the scope of SFFAS Standard No. 5, which is the controlling standard for Federal entities in this situation. Guarantees are included in SFFAS Standard No. 5 ¶ 2, which explicitly states that the standard: "...provides more detailed guidance regarding liabilities resulting from deferred compensation, insurance and guarantees (except social insurance)...." Second, SFFAS Standard No. 5 ¶ 97 defines insurance and guarantee programs as: "Federal government programs that provide protection to individuals or entities against specified risks." Because the Federal government frequently commingles aspects of insurance and guarantees within the same program, this Statement treats the terms as a single type of activity.[3] As such, the Commitments are a "guarantee" or "insurance" against the specified risk of GSEs' liabilities exceeding their assets. When that condition occurs and is measurable with sufficient reliability, the Department will recognize an expense and liability. Lastly, SFFAS Standard No. 5 ¶ 109 provides specific guidance on the valuation for an insurance or guarantee program (see Mechanics of Accounting below).

Measurement Methodology

FASAB Standard No. 5 supports discounted cash flows as the appropriate measurement methodology. FASAB Standard No. 5 ¶ 109 specifically allows for discounted cash flows for Federal insurance and guarantee programs, stating "When payments and losses extend beyond the current year, net losses should be calculated on a present value basis to reflect the time value of money." The FASAB Standard as noted above is the appropriate source of GAAP for this Agreement.

In addition, paragraph 34 of Standard 5 defines "measurability" as meaning the future liability can be quantified in monetary terms with *sufficient reliability*. If the future liability does not meet the "sufficient reliability" standard, then the potential liability should not be recorded on the face of the financial statements, but should be disclosed in the footnotes.

After the end of each quarter, the conservator will determine if either GSE's liabilities exceed its assets, and inform the Department of the need for a liquidity payment. Thus, any quarterly payments will be readily determinable. If a GSE's liabilities exceed its assets, then an "insurable event" will have occurred and we will record an expense and corresponding liability as of the end of the previous quarter, if the amount can be know before we issue the Department's financial statements. As these events will occur after the end of each quarter, they will in effect

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[2] FIN 46 basis for conclusion paragraphs D17 and D18.
[3] Statement of Federal Financial Accounting Standards (SFFAS), No. 5, *Accounting for Liabilities*.

represent "insured but not recorded" claims for events that actually happened in the preceding quarter.

Mechanics of Accounting

According to FASAB Standard No. 5 ¶ 103-104, a guarantee should be recognized on similar terms as Federal credit programs, in which the Federal government is committed at the time the guarantee is extended to bearing the losses inherent in the terms and conditions. To this end, as stated in FASAB Standard No. 5 ¶ 190, an expense and corresponding liability should be recognized for events that have occurred in the past and probable events to occur in the future that are measurable. The Department hired an independent valuation firm to assist with the cash flow model to properly measure the probable liability to the Federal government as of September 30, 2008. The firm concluded that its estimate does not have sufficient reliability to be recorded as a liability. The valuation of the liability will be re-evaluated and adjusted periodically based on execution of the guarantee and/or changing market conditions and other economic assumptions.

Ideally the total liability at the end of any accounting period should include the amount of quarterly liquidity draws requested but not yet paid, accruals for amounts of liquidity draws not known until after the end of the quarter, and an estimated contingent liability for the discounted present value of future liquidity draws up to the $200 billion combined liability limit. The discounted present value would take into account estimated offsetting increases in the liquidity preference of the preferred stock, increases in dividends on the increased liquidity preference, and annual commitment fees. However, for FY 2008 the estimated contingent liability amount does not have "sufficient reliability" and therefore can not be recorded as a liability. The only expense/liability that can be recorded for FY 2008 is the "IBNR" draw request received from FHFA in November 2008.

The transactions surrounding the preferred stock purchase agreement have elements of both "entity" and "non-entity" transactions. The preferred stock and common stock warrants received as the initial commitment fee are "non-entity," as any proceeds from future sale or receipt of the liquidation preference will be returned to the General Fund. Any such proceeds may not be retained by the Department to pay expenses, create obligational authority, etc. The same is true for any future increases in the preferred stock liquidity preference resulting from any quarterly cash infusions to the GSEs.

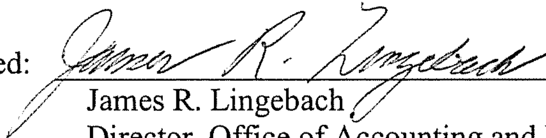
On the other hand, the Department received an appropriation for any payments that may be required under the liquidity commitment. No additional funding for any liability that may arise pursuant to the liquidity commitment needs to be provided by the General Fund. Therefore any liability recorded for the liquidity commitment will be classified as an "entity" liability, with a corresponding debit to an entity expense account. As quarterly liquidity payments are actually made, the liability will be debited and Fund Balance with Treasury credited. Concurrently, the preferred stock investment account will be debited, and the Due to the General Fund account credited.

For FY 08 we have recorded the liability for the draw request received in November 2008, and the related expense, but have not recorded the corresponding increase in liquidity value as we

will not receive that until the payment is actually made. We considered recording a "deferred asset" as of 9/30/08 for the increase in preferred stock liquidity value. However, we did not have enough information to determine the amount of the quarterly draw would actually represent a net asset due to the uncertainties of the situation.

The carrying value of the preferred stock/warrants and commitment liability will need to be assessed at least annually, and entries made to reflect any changes in valuation if a permanent impairment is determined to exist. If the value decreases, the Due to General Fund accounts will be debited, with credits to a contra asset account. (No entries would be made for increases in value.) If the stock or warrants are sold, the associated loss or gain would be recognized in a manner that reflects the non-entity classification of the investments.

Since the Department of the Treasury is administering this program on behalf of the Federal government, the senior preferred stock and common stock warrants will be categorized as non-entity assets on the balance sheet with a corresponding liability to the General Fund of the U.S. Government. This treatment will provide transparency in reporting the asset without unduly inflating the Department's equity for the stocks that belong to the Federal government rather than the Department.

Approved: 

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CAPITAL PURCHASE PROGRAM
Transaction Report
Updated on November 25, 2008; 4:30 PM

	Date	Seller			Transaction Type	Description	Price Paid	Pricing Mechanism
		Name of Institution	City	State				
	10/28/2008	Bank of America Corporation	Charlotte	NC	Purchase	Preferred Stock w/Warrants	$15,000,000,000	Par
	10/28/2008	Bank of New York Mellon Corporation	New York	NY	Purchase	Preferred Stock w/Warrants	$3,000,000,000	Par
	10/28/2008	Citigroup Inc.	New York	NY	Purchase	Preferred Stock w/Warrants	$25,000,000,000	Par
	10/28/2008	The Goldman Sachs Group, Inc.	New York	NY	Purchase	Preferred Stock w/Warrants	$10,000,000,000	Par
	10/28/2008	JPMorgan Chase & Co.	New York	NY	Purchase	Preferred Stock w/Warrants	$25,000,000,000	Par
	10/28/2008	Morgan Stanley	New York	NY	Purchase	Preferred Stock w/Warrants	$10,000,000,000	Par
	10/28/2008	State Street Corporation	Boston	MA	Purchase	Preferred Stock w/Warrants	$2,000,000,000	Par
	10/28/2008	Wells Fargo & Company	San Francisco	CA	Purchase	Preferred Stock w/Warrants	$25,000,000,000	Par
1/	10/28/2008	Merrill Lynch & Co., Inc.	New York	NY	Purchase	Preferred Stock w/Warrants	$10,000,000,000	Par
	11/14/2008	Bank of Commerce Holdings	Redding	CA	Purchase	Preferred Stock w/Warrants	$17,000,000	Par
	11/14/2008	1st FS Corporation	Hendersonville	NC	Purchase	Preferred Stock w/Warrants	$16,369,000	Par
	11/14/2008	UCBH Holdings, Inc.	San Francisco	CA	Purchase	Preferred Stock w/Warrants	$298,737,000	Par
	11/14/2008	Northern Trust Corporation	Chicago	IL	Purchase	Preferred Stock w/Warrants	$1,576,000,000	Par
	11/14/2008	SunTrust Banks, Inc.	Atlanta	GA	Purchase	Preferred Stock w/Warrants	$3,500,000,000	Par
	11/14/2008	Broadway Financial Corporation	Los Angeles	CA	Purchase	Preferred Stock w/Warrants	$9,000,000	Par
	11/14/2008	Washington Federal Inc.	Seattle	WA	Purchase	Preferred Stock w/Warrants	$200,000,000	Par
	11/14/2008	BB&T Corp.	Winston-Salem	NC	Purchase	Preferred Stock w/Warrants	$3,133,640,000	Par
	11/14/2008	Provident Bancshares Corp.	Baltimore	MD	Purchase	Preferred Stock w/Warrants	$151,500,000	Par
	11/14/2008	Umpqua Holdings Corp.	Portland	OR	Purchase	Preferred Stock w/Warrants	$214,181,000	Par
	11/14/2008	Comerica Inc.	Dallas	TX	Purchase	Preferred Stock w/Warrants	$2,250,000,000	Par
	11/14/2008	Regions Financial Corp.	Birmingham	AL	Purchase	Preferred Stock w/Warrants	$3,500,000,000	Par
	11/14/2008	Capital One Financial Corporation	McLean	VA	Purchase	Preferred Stock w/Warrants	$3,555,199,000	Par
	11/14/2008	First Horizon National Corporation	Memphis	TN	Purchase	Preferred Stock w/Warrants	$866,540,000	Par
	11/14/2008	Huntington Bancshares	Columbus	OH	Purchase	Preferred Stock w/Warrants	$1,398,071,000	Par
	11/14/2008	KeyCorp	Cleveland	OH	Purchase	Preferred Stock w/Warrants	$2,500,000,000	Par
	11/14/2008	Valley National Bancorp	Wayne	NJ	Purchase	Preferred Stock w/Warrants	$300,000,000	Par
	11/14/2008	Zions Bancorporation	Salt Lake City	UT	Purchase	Preferred Stock w/Warrants	$1,400,000,000	Par
	11/14/2008	Marshall & Ilsley Corporation	Milwaukee	WI	Purchase	Preferred Stock w/Warrants	$1,715,000,000	Par
	11/14/2008	U.S. Bancorp	Minneapolis	MN	Purchase	Preferred Stock w/Warrants	$6,599,000,000	Par
	11/14/2008	TCF Financial Corporation	Wayzata	MN	Purchase	Preferred Stock w/Warrants	$361,172,000	Par
	11/21/2008	First Niagara Financial Group	Lockport	NY	Purchase	Preferred Stock w/Warrants	$184,011,000	Par
	11/21/2008	HF Financial Corp.	Sioux Falls	SD	Purchase	Preferred Stock w/Warrants	$25,000,000	Par
	11/21/2008	Centerstate Banks of Florida Inc.	Davenport	FL	Purchase	Preferred Stock w/Warrants	$27,875,000	Par
	11/21/2008	City National Corporation	Beverly Hills	CA	Purchase	Preferred Stock w/Warrants	$400,000,000	Par

CAPITAL PURCHASE PROGRAM
Transaction Report
Updated on November 25, 2008; 4:30 PM

Date	Seller			Transaction Type	Description	Price Paid	Pricing Mechanism
	Name of Institution	City	State				
11/21/2008	First Community Bankshares Inc.	Bluefield	VA	Purchase	Preferred Stock w/Warrants	$41,500,000	Par
11/21/2008	Western Alliance Bancorporation	Las Vegas	NV	Purchase	Preferred Stock w/Warrants	$140,000,000	Par
11/21/2008	Webster Financial Corporation	Waterbury	CT	Purchase	Preferred Stock w/Warrants	$400,000,000	Par
11/21/2008	Pacific Capital Bancorp	Santa Barbara	CA	Purchase	Preferred Stock w/Warrants	$180,634,000	Par
11/21/2008	Heritage Commerce Corp.	San Jose	CA	Purchase	Preferred Stock w/Warrants	$40,000,000	Par
11/21/2008	Ameris Bancorp	Moultrie	GA	Purchase	Preferred Stock w/Warrants	$52,000,000	Par
11/21/2008	Porter Bancorp Inc.	Louisville	KY	Purchase	Preferred Stock w/Warrants	$35,000,000	Par
11/21/2008	Banner Corporation	Walla Walla	WA	Purchase	Preferred Stock w/Warrants	$124,000,000	Par
11/21/2008	Cascade Financial Corporation	Everett	WA	Purchase	Preferred Stock w/Warrants	$38,970,000	Par
11/21/2008	Columbia Banking System, Inc.	Tacoma	WA	Purchase	Preferred Stock w/Warrants	$76,898,000	Par
11/21/2008	Heritage Financial Corporation	Olympia	WA	Purchase	Preferred Stock w/Warrants	$24,000,000	Par
11/21/2008	First PacTrust Bancorp, Inc.	Chula Vista	CA	Purchase	Preferred Stock w/Warrants	$19,300,000	Par
11/21/2008	Severn Bancorp, Inc.	Annapolis	MD	Purchase	Preferred Stock w/Warrants	$23,393,000	Par
11/21/2008	Boston Private Financial Holdings, Inc.	Boston	MA	Purchase	Preferred Stock w/Warrants	$154,000,000	Par
11/21/2008	Associated Banc-Corp	Green Bay	WI	Purchase	Preferred Stock w/Warrants	$525,000,000	Par
11/21/2008	Trustmark Corporation	Jackson	MS	Purchase	Preferred Stock w/Warrants	$215,000,000	Par
11/21/2008	First Community Corporation	Lexington	SC	Purchase	Preferred Stock w/Warrants	$11,350,000	Par
11/21/2008	Taylor Capital Group	Rosemont	IL	Purchase	Preferred Stock w/Warrants	$104,823,000	Par
11/21/2008	Nara Bancorp, Inc.	Los Angeles	CA	Purchase	Preferred Stock w/Warrants	$67,000,000	Par

TOTAL $161,471,163,000

1/ Settlement deferred pending merger

KEY	
Date	When payment is authorized
Seller	Name, City and State of Qualified Institution
Transaction Type	Purchase or Sale
Description	e.g. Preferred Stock w/Warrants, Preferred Stock w/Senior Debt
Price Paid	Total Purchase Amount
Pricing Mechanism	e.g. Priced at par, auction price

SYSTEMICALLY SIGNIFICANT FAILING INSTITUTION
Transaction Report

Updated on November 26, 2008; 4:30 PM

Date	Seller			Transaction Type	Description	Price Paid	Pricing Mechanism
	Name of Institution	City	State				
11/25/2008	AIG	New York	NY	Purchase	Preferred Stock w/Warrants	$40,000,000,000	Par

KEY

Date	When payment is authorized
Seller	Name, City and State of Qualified Institution
Transaction Type	Purchase or Sale
Description	e.g. Preferred Stock w/Warrants, Preferred Stock w/Senior Debt
Price Paid	Total Purchase Amount
Pricing Mechanism	e.g. Priced at par, auction price

UNITED STATES DEPARTMENT OF THE TREASURY TRANCHE REPORT TO CONGRESS FOR THE PERIOD THROUGH NOVEMBER 14, 2008

I. INTRODUCTION

This *Second Tranche Report to Congress* (Second Tranche Report) is the second report under section 105(b) of the Emergency Economic Stabilization Act of 2008 (EESA). The Second Tranche Report satisfies the requirements for reporting at the $150 billion cumulative commitment level and is required because Treasury has made funding commitments of approximately $158.5 billion under EESA. Treasury will submit the next tranche report when the commitment level reaches the $200 billion level.

The Second Tranche Report addresses the following six areas as required by EESA section 105(b)(1):

- A description of all the transactions made during the reporting period.
- A description of the pricing mechanism for the transactions.
- A justification of the price paid for, and other financial terms associated with, the transactions.
- A description of the impact of the exercise of such authority on the financial system.
- A description of challenges that remain in the financial system, including any benchmarks yet to be achieved.
- An estimate of additional actions under the authority provided pursuant to EESA that may be necessary to address such challenges.

II. TRANSACTION INFORMATION BY PROGRAM

Treasury has announced two programs to purchase troubled assets under EESA, the Capital Purchase Program (CPP) and the Systemically Significant Failing Institution Program (SSFI). Treasury published the program description for the CPP on October 14, 2008, and completed its first transactions under that program on October 28, 2008. We reported on these transactions, which totaled $125 billion, in the First Tranche Report on November 4. Treasury completed a second set of transactions under the CPP on November 14, 2008, bringing the total amount of funds committed under the CPP program to $158.5 billion. We discuss these recent transactions in this report.

On November 10, Treasury announced an agreement in principle for a $40 billion purchase of preferred shares of American International Group, Inc. (AIG) under the SSFI program**.** Concurrent with publishing this report, Treasury published a description of the SSFI program on its web site. Since the transaction has not been completed as of the time of this report, we will discuss the SSFI Program and the AIG transaction in the next tranche report, when Treasury reaches the $200 billion level.

Capital Purchase Program

The purpose of the CPP is to encourage U.S. financial institutions to build their capital base, which in turn will increase the capacity of those institutions to lend to U.S. businesses and consumers and to support the U.S. economy and stabilize the financial system. The terms of the investment limit certain uses of capital by the issuer, including most repurchases of company stock, and increases in dividends. Under this voluntary program, Treasury will purchase up to $250 billion of senior preferred shares on standardized terms, which will include warrants for future Treasury purchases of common stock. The CPP is available to qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies engaged solely or predominately in financial activities permitted under the relevant law.

Through November 14, Treasury has signed final agreements with 30 financial institutions. On October 28, 2008, Treasury completed capital purchase transactions with 8 of these institutions for a total of $115 billion. Treasury completed capital purchase transactions with an additional 21 institutions on November 14, 2008 for a total of $33.5 billion. Funding of the capital purchase transaction for the thirtieth institution will be made sometime before January 31, 2009 in the amount of $10 billion. A report listing each of these transactions has been published on Treasury's web site.

All commitments thus far under the CPP have been with financial institutions whose stock is traded on national securities exchanges. The terms of the program for non-publicly held financial institutions (excluding S corporations and Mutual Organizations) whose stock is not traded on national securities exchanges were released on November 17 and these institutions have until December 8 to apply. The application process – with standardized forms and standardized review – encourages banks and thrifts of all sizes to participate in the CPP. To apply for the CPP, financial institutions review the program information on the Treasury website and then consult with their Federal banking agency. After this consultation, institutions submit an application to that same Federal banking agency. The minimum subscription amount available to a participating institution is 1 percent of risk-weighted assets. The maximum subscription amount is the lesser of $25 billion or 3 percent of risk-weighted assets. These amounts are determined at the discretion of the Treasury reflecting the recommendations of the Federal banking agency.

Treasury has worked with the Federal banking agencies to establish streamlined evaluation procedures; this means that all Federal banking agencies use a standardized process to review all applications to ensure consistency. Once a regulator has reviewed an application, it sends the application along with its recommendation to the Office of Financial Stability at Treasury. Once Treasury receives the application with the Federal banking agency's recommendation, Treasury reviews it and decides whether or not to make the capital purchase. Treasury values the expertise of the Federal banking agencies, and gives considerable weight to their recommendations. Consistent with the provisions of EESA, all transactions are publicly announced within 2 business days of completion. Treasury will not, however, announce any applications that are withdrawn or denied.

Treasury created the CPP to encourage U.S. financial institutions to obtain capital to strengthen the financial system and increase the flow of financing to U.S. businesses and consumers. In order for the CPP to achieve its objective, a broad class of financial institutions must participate. Therefore, Treasury is making capital temporarily available on attractive terms to a broad array of banks and thrifts, so they can provide credit to our economy. The federal regulatory agencies issued a joint interagency statement on November 12 with respect to lending to creditworthy borrowers.

Treasury has offered the same basic terms to all financial institutions participating in the CPP. Because of the differences between publicly-traded and non-publicly traded financial institutions, there are separate term sheets for each type of financial institution. Treasury, in consultation with the Federal banking regulators, set the preferred stock coupon rate at 5 percent for the first five-years after purchase in order to encourage financial institutions across the country to utilize this program. The dividend rate steps up to 9 percent after five years. The terms of the preferred shares contain certain provisions to protect the taxpayer. These terms include a restriction on paying dividends for both preferred shares equal or junior to Treasury's investment and common shares unless the institution is currently paying full dividends to Treasury (subject to certain exceptions), a restriction on increasing common dividends, and limits on the institution's ability to repurchase other preferred and common shares within 3 years after the Treasury investment. In addition, pursuant to EESA requirements, under terms applicable to publicly held financial institutions, Treasury also receives warrants for common shares in participating institutions to allow the taxpayer to benefit from any appreciation in the market value of the institution. Under terns applicable to non-publicly held financial institutions, Treasury receives warrants for preferred shares that bear dividends at a rate of 9% per annum. Institutions that sell shares to the government also accept restrictions on executive compensation promulgated under EESA during the period that Treasury holds equity issued through the CPP. Treasury expects all participating institutions to increase their lending activities in a safe and sound manner to benefit U.S. businesses and consumers.

Appendix 1 contains the detailed transaction report through November 14 as released on November 17, 2008. Appendix 2 contains the CPP term sheet for non-publicly held financial institutions.

III. ASSESSMENT OF CURRENT MEASURES AND THE CHALLENGES AHEAD

Impact of the Transactions

Treasury's initial objective has been to stabilize the financial system and the CPP, in conjunction with the FDIC's guarantee of certain financial institution debt, has been essential in accomplishing that objective. Capital purchases are clearly powerful in terms of impact per dollar invested. More capital enables banks to withstand losses as they write down or sell troubled assets and stronger capitalization is also vital to increasing lending, an essential element for economic recovery. Through the CPP, we have added over $158 billion into the banking system's capital structure.

Treasury has moved rapidly to review applications and make investments in federally regulated banks and thrifts. In one month, Treasury completed transactions with 30 financial institutions. We have granted preliminary approval of applications for dozens of additional institutions as well and are working with these institutions to complete the legal agreements and fund the investments. A term sheet for non-publicly traded financial institutions (excluding S corporations and Mutual Organizations) has been released and there is continued interest in participating in the CPP from financial institutions of all sizes.

Challenges That Lie Ahead and Additional Actions

Since initiating the CPP, Treasury has been examining a wide range of ideas that can further strengthen the financial system and revive lending to support the broader economy. Because the system remains fragile, systemic failures must be prevented as illustrated by the AIG announcement.

Treasury has three critical priorities for investing the remaining TARP funds. We will continue to reinforce the stability of the financial system, so that banks and other institutions are able to support economic recovery and growth. For example, approaches are being evaluated that will leverage TARP funding through matching investments. We are also exploring ways to support markets for securitizing credit outside the banking system. This vital market has, for all practical purposes, ground to a halt. With the Federal Reserve, Treasury is exploring the development of a liquidity facility for highly rated asset-backed securities. In addition, we are evaluating ways to reduce the risk of foreclosure. Treasury will continue its efforts to support the variety of programs across government that are already well underway.

UNITED STATES DEPARTMENT OF THE TREASURY
TRANCHE REPORT TO CONGRESS
NOVEMBER 4, 2008

I. INTRODUCTION

This *First Tranche Report to Congress* (First Tranche Report) is the first report under section 105(b) of the Emergency Economic Stabilization Act of 2008 (EESA). This First Tranche Report is in satisfaction of the requirements for reporting at the $50 billion and $100 billion commitment levels, because Treasury has made in one round of funding commitments of approximately $125 billion under EESA. Treasury will submit the next tranche report when commitment levels reach the $150 billion level.

The First Tranche Report addresses the following six areas as required by EESA section 105(b)(1):

- A description of all the transactions made during the reporting period.
- A description of the pricing mechanism for the transactions.
- A justification of the price paid for, and other financial terms associated with, the transactions.
- A description of the impact of the exercise of such authority on the financial system.
- A description of challenges that remain in the financial system, including any benchmarks yet to be achieved.
- An estimate of additional actions under the authority provided pursuant to EESA that may be necessary to address such challenges.

II. TRANSACTION INFORMATION BY PROGRAM

On October 14, 2008, Treasury published the program description for the Capital Purchase Program (CPP) and made available $250 billion of purchase authority for the CPP. Treasury has committed 100 percent of the dollars at the $50 billion and $100 billion commitment levels under the CPP. These commitment levels were reached on October 28, 2008.

As of the date of this First Tranche Report, no purchases or commitments to purchase have been made under any other program established under EESA.

Capital Purchase Program

The purpose of the CPP is to encourage U.S. financial institutions to build their capital base, which in turn will increase the capacity of those institutions to lend to U.S. businesses and consumers and to support the U.S. economy. The terms of the investment limit certain uses of capital by the issuer, including most repurchases of company stock, and increases in dividends. Under this voluntary program, Treasury will purchase up to $250 billion of senior preferred shares on standardized terms, which will include warrants for future Treasury purchases of

common stock. The CPP is available to qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies engaged solely or predominately in financial activities permitted under the relevant law.

To date, Treasury has signed final agreements with 9 financial institutions holding 50 percent of all U.S. deposits. On October 28, 2008, Treasury settled capital purchase transactions with 8 of these institutions for a total of $115 billion. Settlement of the capital purchase transaction for the last institution will be made sometime before January 31, 2009.

Treasury announced the CPP on October 14, 2008. On October 20, 2008, Treasury announced a streamlined, systematic process for all publicly organized financial institutions wishing to access funds through the CPP. Treasury will post an application form and term sheet for privately held eligible institutions and establish a reasonable application deadline for private institutions.

This process for publicly organized financial institutions – with standardized forms and standardized review – encourages banks and thrifts of all sizes to participate in the CPP. Treasury worked closely with the four Federal banking agencies to finalize both the application process and a standardized evaluation process. To apply for the CPP, financial institutions review the program information on the Treasury website and then consult with their Federal banking agency. After this consultation, institutions submit an application to that same Federal banking agency. The minimum subscription amount available to a participating institution is 1 percent of risk-weighted assets. The maximum subscription amount is the lesser of $25 billion or 3 percent of risk-weighted assets.

Treasury has worked with the Federal banking agencies to establish streamlined evaluations; this means that all Federal banking agencies will use a standardized process to review all applications to ensure consistency. Once a regulator has reviewed an application, it will send the application along with its recommendation to the Office of Financial Stability at Treasury. Once Treasury receives the application with the Federal banking agency's recommendation, Treasury will review it and decide whether or not to make the capital purchase. Treasury welcomes the expertise of the Federal banking agencies, and will give considerable weight to their recommendations. Consistent with the provisions of EESA, all transactions will be publicly announced within 48 hours of completion. Treasury will not, however, announce any applications that are withdrawn or denied.

Treasury created the CPP to encourage U.S. financial institutions to obtain capital to strengthen the financial system and increase the flow of financing to U.S. businesses and consumers. In order for the CPP to achieve its objective, a broad class of financial institutions must participate. Therefore, Treasury is making capital temporarily available on attractive terms to a broad array of banks and thrifts, so they can provide credit to our economy. Treasury, in consultation with the Federal banking regulators, set a preferred stock coupon rate at 5 percent over the first five-year period in order to encourage financial institutions across the country to utilize this program. The dividend rate steps up to 9 percent after five years. The terms of the preferred shares contain certain provisions to protect the taxpayer. These terms include a restriction on paying dividends for both preferred shares equal or junior to Treasury's investment and common shares unless the institution is currently paying full dividends to Treasury (subject to certain exceptions), a

restriction on increasing common dividends for 3 years, and limits on the ability to repurchase other preferred and common shares within 3 years. In addition, pursuant to EESA requirements, Treasury will also receive warrants for common shares in participating institutions to allow the taxpayer to benefit from any appreciation in the market value of the institution. Institutions that sell shares to the government accept restrictions on executive compensation promulgated under EESA during the period that Treasury holds equity issued through the CPP. Treasury expects all participating institutions to increase their lending activities in a safe and sound manner to benefit U.S. businesses and consumers.

Appendix 1 contains the detailed transaction report released on October 29, 2008. Appendix 2 contains the term sheet for publicly traded banks.

III. ASSESSMENT OF CURRENT MEASURES AND THE CHALLENGES AHEAD

Impact of the Transactions

Treasury acted aggressively to implement the CPP to provide market stability and strengthen financial institutions across the country. As banks and institutions are reinforced and supported with taxpayer funds, Treasury expects they will increase lending to support the American people and the U.S. economy. With the additional capital, it is in the now-strengthened institutions' best financial interests to increase lending.

It is premature to assess the impact of the CPP, because less than half of the funds for this program have been invested, and those funds were invested only one week ago. Nevertheless, Treasury is encouraged by recent signs of improvement in the markets and in the confidence in our financial institutions. Policy measures implemented by Treasury, the Federal Reserve, the Federal Deposit Insurance Corporation, other U.S. policymakers and our counterparts around the world have helped relieve some pressures in the funding market.

Several funding market indicators, including the London Interbank Offered Rates (LIBOR), have experienced improvements since the passage and implementation of EESA and other policy actions. In the longer term credit markets, however, conditions remain quite challenging, and U.S. companies continue to find it difficult to issue long-term debt at attractive rates.

Challenges That Lie Ahead

Although actions announced to date have had a positive effect on the market, challenges remain. Equity, credit, and funding markets remain under considerable strain, as banks have been forced to reduce their leverage dramatically and have lowered their risk appetite. In addition, the primary and secondary mortgage finance markets are impaired by reduced liquidity.

Treasury is committed to deploying the TARP aggressively and is actively considering additional programs to strengthen financial institutions, restore the flow of lending, and address the many challenges to our financial markets posed by the ongoing housing correction. Treasury has policy teams examining several different areas that show promise for helping to strengthen our financial markets and preserve home ownership. In particular, Treasury will continue efforts to

ensure loan modifications are sustainable; to reach and communicate with borrowers effectively; to help borrowers avoid default; and to address high Real Estate Owned (REO) and vacancy rates, some of the factors destabilizing neighborhoods.

Programs will be designed to include requirements on executive compensation and warrants as appropriate to ensure compliance with EESA statutory provisions. To date, no final decisions have been made regarding actions that Treasury might take in any of these areas. Treasury will take additional steps to restore financial market stability in a clear and efficient manner while ensuring that the taxpayer is properly protected.

FEDERAL HOUSING FINANCE AGENCY

FACT SHEET

Contact: Corinne Russell (202) 414-6921
Stefanie Mullin (202) 414-6376

QUESTIONS AND ANSWERS ON CONSERVATORSHIP

Q: What is a conservatorship?

A: A conservatorship is the legal process in which a person or entity is appointed to establish control and oversight of a Company to put it in a sound and solvent condition. In a conservatorship, the powers of the Company's directors, officers, and shareholders are transferred to the designated Conservator.

Q: What is a Conservator?

A: A Conservator is the person or entity appointed to oversee the affairs of a Company for the purpose of bringing the Company back to financial health.

In this instance, the Federal Housing Finance Agency ("FHFA") has been appointed by its Director to be the Conservator of the Company in accordance with the Federal Housing Finance Regulatory Reform Act of 2008 (Public Law 110-289) and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4501, et seq., as amended) to keep the Company in a safe and solvent financial condition.

Q: How is a Conservator appointed?

A: By statute, the FHFA is appointed Conservator by its Director after the Director determines, in his discretion, that the Company is in need of reorganization or rehabilitation of its affairs.

Q: What are the goals of this conservatorship?

A: The purpose of appointing the Conservator is to preserve and conserve the Company's assets and property and to put the Company in a sound and solvent condition. The goals of the conservatorship are to help restore confidence in the Company, enhance its capacity to fulfill its mission, and mitigate the systemic risk that has contributed directly to the instability in the current market.

There is no reason for concern regarding the ongoing operations of the Company. The Company's operation will not be impaired and business will continue without interruption.

Q: When will the conservatorship period end?

A: Upon the Director's determination that the Conservator's plan to restore the Company to a safe and solvent condition has been completed successfully, the Director will issue an order terminating the conservatorship. At present, there is no exact time frame that can be given as to when this conservatorship may end.

Q: What are the powers of the Conservator?

A: The FHFA, as Conservator, may take all actions necessary and appropriate to (1) put the Company in a sound and solvent condition and (2) carry on the Company's business and preserve and conserve the assets and property of the Company.

Q: What happens upon appointment of a Conservator?

A: Once an "Order Appointing a Conservator" is signed by the Director of FHFA, the Conservator immediately succeeds to the (1) rights, titles, powers, and privileges of the Company, and any stockholder, officer, or director of such the Company with respect to the Company and its assets, and (2) title to all books, records and assets of the Company held by any other custodian or third-party. The Conservator is then charged with the duty to operate the Company.

Q: What does the Conservator do during a conservatorship?

A: The Conservator controls and directs the operations of the Company. The Conservator may (1) take over the assets of and operate the Company with all the powers of the shareholders, the directors, and the officers of the Company and conduct all business of the Company; (2) collect all obligations and money due to the Company; (3) perform all functions of the Company which are consistent with the Conservator's appointment; (4) preserve and conserve the assets and property of the Company; and (5) contract for assistance in fulfilling any function, activity, action or duty of the Conservator.

Q: How will the Company run during the conservatorship?

A: The Company will continue to run as usual during the conservatorship. The Conservator will delegate authorities to the Company's management to move forward with the

business operations. The Conservator encourages all Company employees to continue to perform their job functions without interruption.

Q: Will the Company continue to pays its obligations during the conservatorship?

A: Yes, the Company's obligations will be paid in the normal course of business during the Conservatorship. The Treasury Department, through a secured lending credit facility and a Senior Preferred Stock Purchase Agreement, has significantly enhanced the ability of the Company to meet its obligations. The Conservator does not anticipate that there will be any disruption in the Company's pattern of payments or ongoing business operations.

Q: What happens to the Company's stock during the conservatorship?

A: During the conservatorship, the Company's stock will continue to trade. However, by statute, the powers of the stockholders are suspended until the conservatorship is terminated. Stockholders will continue to retain all rights in the stock's financial worth; as such worth is determined by the market.

Q: Is the Company able to buy and sell investments and complete financial transactions during the conservatorship?

A: Yes, the Company's operations continue subject to the oversight of the Conservator.

Q: What happens if the Company is liquidated?

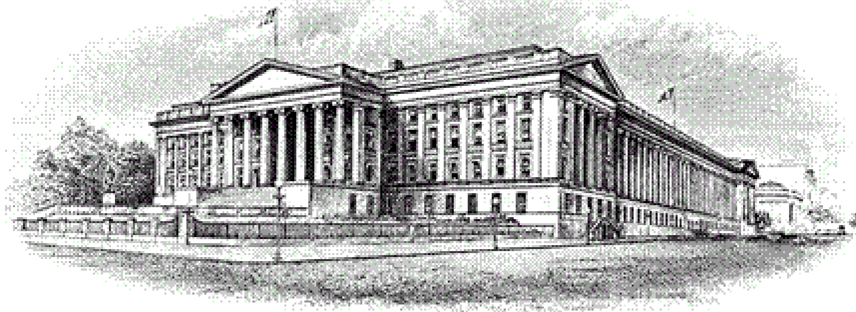
A: Under a conservatorship, the Company is not liquidated.

Q: Can the Conservator determine to liquidate the Company?

A: The Conservator cannot make a determination to liquidate the Company, although, short of that, the Conservator has the authority to run the company in whatever way will best achieve the Conservator's goals (discussed above). However, assuming a statutory ground exists and the Director of FHFA determines that the financial condition of the company requires it, the Director does have the discretion to place any regulated entity, including the Company, into receivership. Receivership is a statutory process for the liquidation of a regulated entity. There are no plans to liquidate the Company.

Q: Can the Company be dissolved?

A: Although the company can be liquidated as explained above, by statute the charter of the Company must be transferred to a new entity and can only be dissolved by an Act of Congress.



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 11 a.m. (EDT), September 7, 2008
CONTACT Brookly McLaughlin, (202) 622-2920

FACT SHEET:
TREASURY SENIOR PREFERRED STOCK PURCHASE AGREEMENT

Fannie Mae and Freddie Mac debt and mortgage backed securities outstanding today amount to about $5 trillion, and are held by central banks and investors around the world. Investors have purchased securities of these government sponsored enterprises in part because the ambiguities in their Congressional charters created a perception of government backing. These ambiguities fostered enormous growth in GSE debt outstanding, and the breadth of these holdings pose a systemic risk to our financial system. Because the U.S. government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt and mortgage backed securities.

To address our responsibility to support GSE debt and mortgage backed securities holders, Treasury entered into a Senior Preferred Stock Purchase Agreement with each GSE which ensures that each enterprise maintains a positive net worth. This measure adds to market stability by providing additional security to GSE debt holders – senior and subordinated-- and adds to mortgage affordability by providing additional confidence to investors in GSE mortgage-backed securities. This commitment also eliminates any mandatory triggering of receivership.

These agreements are the most effective means of averting systemic risk and contain terms and conditions to protect the taxpayer. They are more efficient than a one-time equity injection, in that Treasury will use them only as needed and on terms that the Treasury deems appropriate.

These agreements provide significant protections for the taxpayer, in the form of senior preferred stock with a liquidation preference, an upfront $1 billion issuance of senior preferred stock with a 10% coupon from each GSE, quarterly dividend payments, warrants representing an ownership stake of 79.9% in each GSE going forward, and a quarterly fee starting in 2010.

Terms of the Agreements:

- The agreements are contracts between the Department of the Treasury and each GSE. They are indefinite in duration and have a capacity of $100 billion each, an amount chosen to demonstrate a strong commitment to the GSEs' creditors and mortgage backed security holders. This number is unrelated to the Treasury's analysis of the current financial conditions of the GSEs.

- If the Federal Housing Finance Agency determines that a GSE's liabilities have exceeded its assets under generally accepted accounting principles, Treasury will contribute cash capital to the GSE in an amount equal to the difference between liabilities and assets. An amount equal to

each such contribution will be added to the senior preferred stock held by Treasury, which will be senior to all other preferred stock, common stock or other capital stock to be issued by the GSE. These agreements will protect the senior and subordinated debt and the mortgage backed securities of the GSEs. The GSE's common stock and existing preferred shareholders will bear any losses ahead of the government.

- In exchange for entering into these agreements with the GSEs, Treasury will immediately receive the following compensation:
  - $1 billion of senior preferred stock in each GSE
  - Warrants for the purchase of common stock of each GSE representing 79.9% of the common stock of each GSE on a fully-diluted basis at a nominal price

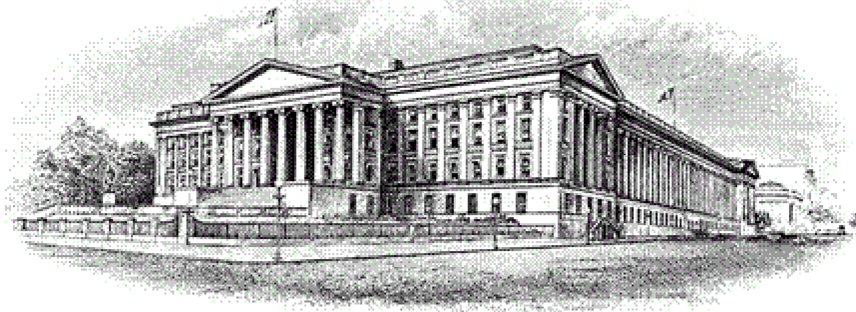
- The senior preferred stock shall accrue dividends at 10% per year. The rate shall increase to 12% if, in any quarter, the dividends are not paid in cash, until all accrued dividends have been paid in cash.

- The senior preferred stock shall not be entitled to voting rights. In a conservatorship, voting rights of all stockholders are vested in the Conservator.

- Beginning March 31, 2010, the GSEs shall pay the Treasury on a quarterly basis a periodic commitment fee that will compensate the Treasury for the explicit support provided by the agreement. The Secretary of the Treasury and the Conservator shall determine the periodic commitment fee in consultation with the Chairman of the Federal Reserve. This fee may be paid in cash or may be added to the senior preferred stock.

- The following covenants apply to the GSEs as part of the agreements.
  - Without the prior consent of the Treasury, the GSEs shall not:
    - Make any payment to purchase or redeem its capital stock, or pay any dividends, including preferred dividends (other than dividends on the senior preferred stock)
    - Issue capital stock of any kind
    - Enter into any new or adjust any existing compensation agreements with "named executive officers" without consulting with Treasury
    - Terminate conservatorship other than in connection with receivership
    - Sell, convey or transfer any of its assets outside the ordinary course of business except as necessary to meet their obligation under the agreements to reduce their portfolio of retained mortgages and mortgage backed securities
    - Increase its debt to more than 110% of its debt as of June 30, 2008
    - Acquire or consolidate with, or merge into, another entity.

- Each GSE's retained mortgage and mortgage backed securities portfolio shall not exceed $850 billion as of December 31, 2009, and shall decline by 10% per year until it reaches $250 billion.



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL, 11 a.m., (EDT), September 7, 2008
CONTACT Brookly McLaughlin, (202) 622-2920

FACT SHEET:
GSE MORTGAGE BACKED SECURITIES PURCHASE PROGRAM

Treasury announced a program today to help improve the availability of mortgage credit to American homebuyers and mitigate pressures on mortgage rates. To promote the stability of the mortgage market, Treasury will purchase Government Sponsored Enterprise (GSE) mortgage-backed securities (MBS) in the open market. By purchasing these guaranteed securities, Treasury seeks to broaden access to mortgage funding for current and prospective homeowners as well as to promote market stability.

Scope of Program. Treasury is committed to investing in agency MBS with the size and timing subject to the discretion of the Treasury Secretary. The scale of the program will be based on developments in the capital markets and housing markets.

- Congress granted Treasury authority to purchase MBS in the Housing and Economic Recovery Act of 2008. The authority expires on December 31, 2009.
- Treasury will begin later this month by investing in new GSE MBS, which are credit-guaranteed by the GSEs. Additional purchases will be made as deemed appropriate.
- Treasury can hold this portfolio of MBS to maturity and, based on mortgage market conditions, Treasury may make adjustments to the portfolio.

Management. Treasury will designate independent asset managers as financial agents to undertake the purchase and management of a portfolio of GSE MBS on behalf of Treasury.

- The portfolios will be managed with clear investment guidelines and investment objectives.
- The primary objectives of this portfolio will be to promote market stability, ensure mortgage availability, and protect the taxpayer.

Risk. Treasury is committed to protecting taxpayers and will ensure that measures are in place to reduce the potential for investment loss.

- Under most likely scenarios, taxpayers will benefit from this program - both indirectly through the increased availability and lower cost of mortgage financing, and directly through potential returns on Treasury's portfolio of MBS.

Budget Implications. Given that Treasury can hold these securities to maturity, the spreads between Treasury's cost of borrowing and GSE MBS indicate that there is no reason to expect taxpayer losses from this program.

- Treasury financing of purchases of GSE MBS will be deemed as outlays and are subject to the statutory debt limit.
- However, Treasury will be receiving an income producing asset (a portfolio of GSE MBS) in return for its invested funds.
- Treasury will make available information on purchases through this program in the Monthly Treasury Statement (http://fms.treas.gov/mts/index.html).

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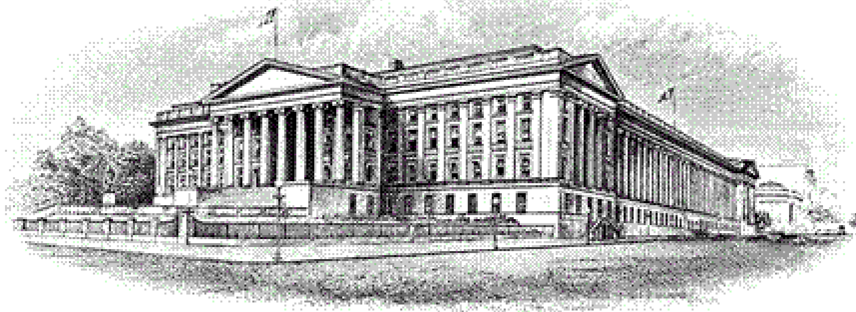


U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL, 11 a.m., (EDT), September 7, 2008
CONTACT Brookly McLaughlin, (202) 622-2920

FACT SHEET:
GOVERNMENT SPONSORED ENTERPRISE CREDIT FACILITY

The Government Sponsored Enterprise Credit Facility (GSECF) announced today by Treasury to ensure credit availability to the housing GSEs is a lending facility that will provide secured funding on an as needed basis under terms and conditions established by the Treasury Secretary to protect taxpayers. Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are eligible to borrow under this program if needed.

The facility will offer liquidity if needed until December 31, 2009. The Housing and Economic Recovery Act of 2008 provided Treasury with the authority to establish this facility.

Funding. Funding will be provided directly by Treasury from its general fund held at the Federal Reserve Bank of New York (FRBNY) in exchange for eligible collateral from the GSEs which will be limited to guaranteed mortgage backed securities issued by Freddie Mac and Fannie Mae as well as advances made by the Federal Home Loan Banks. All such assets pledged against loans will be accepted with appropriate collateral margins as determined by Treasury.

- The FRBNY will act as Treasury's fiscal agent to advance funds to the GSEs and to administer collateral arrangements.
- Any lending through the GSECF will be directly debited from Treasury's general account and credited to the borrowing GSE's account, both held at the FRBNY.
- Loan requests will require approval from Treasury and verification by the FRBNY that adequate collateral has been pledged.
- Similar to other borrowing done by Treasury, information on any borrowing will be publicly reported at the end of the following day in the Daily Treasury Statement. (http://www.fms.treas.gov/dts/)
- Any additional borrowing by Treasury necessitated by this program would be subject to the debt limit.

Loan Duration and Size. Loans will be for short-term durations and would in general be expected to be for less than one month but no shorter than one week.

- Specific maturities will be determined based on individual loan requests.
- The term of a loan may not be extended, but a maturing loan may be replaced with a new loan under the same borrowing procedures as the initial loan.

- Loans may be pre-paid with two days notice, and loans may be called before their scheduled maturity date.
- Loan amounts will be based on available collateral.
- Loans will not be made with a maturity date beyond December 31, 2009.

Rate. The rate on a loan request ordinarily will be based on the daily LIBOR fix for a similar term of the loan plus 50 basis points (LIBOR +50 bp). The rate is set at the discretion of the Treasury Secretary with the objective of protecting the taxpayer, and is subject to change.

Collateral. All loans will be collateralized and collateral is limited to mortgage backed securities issued by Freddie Mac and Fannie Mae and advances made by the Federal Home Loan Banks.

- The collateral will be valued and managed by Treasury's fiscal agent, the FRBNY, based on a range of pricing services.

PRESS ROOM
U.S. DEPARTMENT OF THE TREASURY

September 11, 2008
HP-1131

Frequently Asked Questions:
Treasury Senior Preferred Stock Purchase Agreement

Can the U.S. Congress or the Executive Branch change the terms of the preferred stock purchase agreement?
This preferred stock purchase agreement is a binding legal obligation between two parties. The agreement is designed to prohibit any amendment that would decrease the amount of Treasury's funding commitment or add funding conditions that would adversely affect debt or mortgage-backed securities holders.

Some may speculate that a future Congress could pass a law that would abrogate the agreement. But any such law would be inconsistent with the U.S. government's longstanding history of honoring its obligations. Such action would also give rise to government liability to parties suing to enforce their rights under the agreement.

The U.S. Government stands behind the preferred stock purchase agreements and will honor its commitments. Contracts are respected in this country as a fundamental part of rule of law.

Can the U.S. Congress or the Executive Branch change the covenants in the agreement, such as the covenant requiring the reduction of the companies' portfolios?
As with any contract, the parties to the agreement may modify the covenants by mutual agreement only.

Does the senior preferred stock purchase agreement protect debt and mortgage backed securities issued or maturing after 2009?
Yes. The holders of senior debt, subordinated debt, and mortgage backed securities issued or guaranteed by these GSEs are protected by the agreement without regard to when those securities were issued or guaranteed. Debt and mortgage backed securities issued or guaranteed both before and after December 31, 2009 are protected by the agreement.

If the preferred stock purchase agreement protects senior and subordinated debt securities issued at any time in the future, how can the agreement ever be terminated?
Treasury's funding commitment in the agreement would terminate under three events:

1. The funding commitment terminates if the commitment is fully funded by Treasury.
2. If a GSE liquidates its assets, its net worth deficiency is computed at that time and the GSE can call upon the Treasury to fund under its preferred stock purchase agreement. After that final funding, the funding commitment in the agreement would terminate.
3. When a GSE satisfies all of its liabilities, whether at maturity or by making some other provision for payment in full of its obligations, the funding commitment will also terminate.

Why is the preferred stock purchase agreement limited to $100 billion? Is that enough to protect against even the worst downside scenario? What happens if losses exceed $100 billion?
Treasury deliberately chose a large number to give confidence to the markets.

If Treasury has already received $1 billion in senior preferred stock, how can you say that no investment has been made yet?
The companies each issued $1 billion in senior preferred stock to Treasury in connection with Treasury's commitment to maintain a positive net worth in the GSE. No taxpayer money was spent to receive this stock.

How is it legal for this preferred stock purchase agreement to be valid beyond the December 31, 2009 expiration of Treasury's authority?
Treasury received the preferred stock and received warrants for common stock as of Sunday September 7, 2008 and will not need to purchase any additional shares relative to this agreement. No payments by the Treasury will be made under this agreement until and unless necessary to prevent a negative net worth position for either GSE.

If the Treasury makes payments under its funding commitment, the liquidation preference of the Treasury shares will increase accordingly

What happens to the declared dividends for investors of existing GSE preferred stock?
Dividends actually declared by a GSE before the date of the senior preferred stock purchase agreement will be paid on schedule.

Can the government exercise its warrants whenever it wants, even if it is disadvantageous to the companies?
Yes. Treasury can exercise its warrant for up to 79.9% of the common stock of each GSE on a fully diluted basis at any time during the 20-year life of the warrant.

What do the rating agencies think of this agreement?
All of the rating agencies have reaffirmed the United States' current rating status.

TAB B - Government Sponsored Enterprises (GSE) Materials

EXECUTION VERSION

SENIOR PREFERRED STOCK PURCHASE AGREEMENT

SENIOR PREFERRED STOCK PURCHASE AGREEMENT (this "Agreement") dated as of September 7, 2008, between the UNITED STATES DEPARTMENT OF THE TREASURY ("Purchaser") and FEDERAL NATIONAL MORTGAGE ASSOCIATION ("Seller"), acting through the Federal Housing Finance Agency (the "Agency") as its duly appointed conservator (the Agency in such capacity, "Conservator"). Reference is made to Article 1 below for the meaning of capitalized terms used herein without definition.

Background

A. The Agency has been duly appointed as Conservator for Seller pursuant to Section 1367(a) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (as amended, the "FHE Act"). Conservator has determined that entry into this Agreement is (i) necessary to put Seller in a sound and solvent condition; (ii) appropriate to carry on the business of Seller and preserve and conserve the assets and property of Seller; and (iii) otherwise consistent with its powers, authorities and responsibilities.

B. Purchaser is authorized to purchase obligations and other securities issued by Seller pursuant to Section 304(g) of the Federal National Mortgage Association Charter Act, as amended (the "Charter Act"). The Secretary of the Treasury has determined, after taking into consideration the matters set forth in Section 304(g)(1)(C) of the Charter Act, that the purchases contemplated herein are necessary to (i) provide stability to the financial markets; (ii) prevent disruptions in the availability of mortgage finance; and (iii) protect the taxpayer.

THEREFORE, the parties hereto agree as follows:

Terms and Conditions

1. DEFINITIONS

As used in this Agreement, the following terms shall have the meanings set forth below:

"*Affiliate*" means, when used with respect to a specified Person (i) any direct or indirect holder or group (as defined in Sections 13(d) and 14(d) of the Exchange Act) of holders of 10.0% or more of any class of capital stock of such Person and (ii) any current or former director or officer of such Person, or any other current or former employee of such Person that currently exercises or formerly exercised a material degree of Control over such Person, including without limitation each current or former Named Executive Officer of such Person.

"*Available Amount*" means, as of any date of determination, the lesser of (a) the Deficiency Amount as of such date and (b) the Maximum Amount as of such date.

"*Business Day*" means any day other than a Saturday, Sunday or other day on which commercial banks are authorized to close under United States federal law and the law of the State of New York.

"*Capital Lease Obligations*" of any Person shall mean the obligations of such Person to pay rent or other amounts under any lease of (or other similar arrangement conveying the right to use) real or personal property, or a combination thereof, which obligations are required to be classified and accounted for as capital leases on a balance sheet of such Person under GAAP and, for purposes hereof, the amount of such obligations at any time shall be the capitalized amount thereof at such time determined in accordance with GAAP.

"*Control*" shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a Person, whether through the ownership of voting securities, by contract or otherwise.

"*Deficiency Amount*" means, as of any date of determination, the amount, if any, by which (a) the total liabilities of Seller exceed (b) the total assets of Seller (such assets excluding the Commitment and any unfunded amounts thereof), in each case as reflected on the balance sheet of Seller as of the applicable date set forth in this Agreement, prepared in accordance with GAAP; provided, however, that:

(i) for the avoidance of doubt, in measuring the Deficiency Amount liabilities shall exclude any obligation in respect of any capital stock of Seller, including the Senior Preferred Stock contemplated herein;

(ii) in the event that Seller becomes subject to receivership or other liquidation process or proceeding, "Deficiency Amount" shall mean, as of any date of determination, the amount, if any, by which (a) the total allowed claims against the receivership or other applicable estate (excluding any liabilities of or transferred to any LLRE (as defined in Section 5.4(a)) created by a receiver) exceed (b) the total assets of such receivership or other estate (excluding the Commitment, any unfunded amounts thereof and any assets of or transferred to any LLRE, but including the value of the receiver's interest in any LLRE);

(iii) to the extent Conservator or a receiver of Seller, or any statute, rule, regulation or court of competent jurisdiction, specifies or determines that a liability of Seller (including without limitation a claim against Seller arising from rescission of a purchase or sale of a security issued by Seller (or guaranteed by Seller or with respect to which Seller is otherwise liable) or for damages arising from the purchase, sale or retention of such a security) shall be subordinated (other than pursuant to a contract providing for such subordination) to all other liabilities of Seller or shall be treated on par with any class of equity of Seller, then such liability shall be excluded in the calculation of Deficiency Amount; and

(iv) the Deficiency Amount may be increased above the otherwise applicable amount by the mutual written agreement of Purchaser and Seller, each acting in its sole discretion.

"*Designated Representative*" means Conservator or (a) if Conservator has been superseded by a receiver pursuant to Section 1367(a) of the FHE Act, such receiver, or (b) if Seller is not in con-

servatorship or receivership pursuant to Section 1367(a) of the FHE Act, Seller's chief financial officer.

"*Director*" shall mean the Director of the Agency.

"*Effective Date*" means the date on which this Agreement shall have been executed and delivered by both of the parties hereto.

"*Equity Interests*" of any Person shall mean any and all shares, interests, rights to purchase or otherwise acquire, warrants, options, participations or other equivalents of or interests in (however designated) equity, ownership or profits of such Person, including any preferred stock, any limited or general partnership interest and any limited liability company membership interest, and any securities or other rights or interests convertible into or exchangeable for any of the foregoing.

"*Exchange Act*" means the Securities Exchange Act of 1934, as amended, and the rules and regulations of the SEC promulgated thereunder.

"*GAAP*" means generally accepted accounting principles in effect in the United States as set forth in the opinions and pronouncements of the Accounting Principles Board and the American Institute of Certified Public Accountants and statements and pronouncements of the Financial Accounting Standards Board from time to time.

"*Indebtedness*" of any Person means, for purposes of Section 5.5 only, without duplication, (a) all obligations of such Person for money borrowed by such Person, (b) all obligations of such Person evidenced by bonds, debentures, notes or similar instruments, (c) all obligations of such Person under conditional sale or other title retention agreements relating to property or assets purchased by such Person, (d) all obligations of such Person issued or assumed as the deferred purchase price of property or services, other than trade accounts payable, (e) all Capital Lease Obligations of such Person, (f) obligations, whether contingent or liquidated, in respect of letters of credit (including standby and commercial), bankers' acceptances and similar instruments and (g) any obligation of such Person, contingent or otherwise, guaranteeing or having the economic effect of guaranteeing any Indebtedness of the types set forth in clauses (a) through (f) payable by another Person other than Mortgage Guarantee Obligations.

"*Liquidation End Date*" means the date of completion of the liquidation of Seller's assets.

"*Maximum Amount*" means, as of any date of determination, $100,000,000,000 (one hundred billion dollars), less the aggregate amount of funding under the Commitment prior to such date.

"*Mortgage Assets*" of any Person means assets of such Person consisting of mortgages, mortgage loans, mortgage-related securities, participation certificates, mortgage-backed commercial paper, obligations of real estate mortgage investment conduits and similar assets, in each case to the extent such assets would appear on the balance sheet of such Person in accordance with GAAP as in effect as of the date hereof (and, for the avoidance of doubt, without giving effect to any

change that may be made hereafter in respect of Statement of Financial Accounting Standards No. 140 or any similar accounting standard).

"*Mortgage Guarantee Obligations*" means guarantees, standby commitments, credit enhancements and other similar obligations of Seller, in each case in respect of Mortgage Assets.

"*Named Executive Officer*" has the meaning given to such term in Item 402(a)(3) of Regulation S-K under the Exchange Act, as in effect on the date hereof.

"*Person*" shall mean any individual, corporation, limited liability company, partnership, joint venture, association, joint-stock company, trust, estate, unincorporated organization or government or any agency or political subdivision thereof, or any other entity whatsoever.

"*SEC*" means the Securities and Exchange Commission.

"*Senior Preferred Stock*" means the Variable Liquidation Preference Senior Preferred Stock of Seller, substantially in the form of Exhibit A hereto.

"*Warrant*" means a warrant for the purchase of common stock of Seller representing 79.9% of the common stock of Seller on a fully-diluted basis, substantially in the form of Exhibit B hereto.

2. COMMITMENT

2.1. *Commitment.* Purchaser hereby commits to provide to Seller, on the terms and conditions set forth herein, immediately available funds in an amount up to but not in excess of the Available Amount, as determined from time to time (the "Commitment"); provided, that in no event shall the aggregate amount funded under the Commitment exceed $100,000,000,000 (one hundred billion dollars). The liquidation preference of the Senior Preferred Stock shall increase in connection with draws on the Commitment, as set forth in Section 3.3 below.

2.2. *Quarterly Draws on Commitment.* Within fifteen (15) Business Days following the determination of the Deficiency Amount, if any, as of the end of each fiscal quarter of Seller which ends on or before the Liquidation End Date, the Designated Representative may, on behalf of Seller, request that Purchaser provide immediately available funds to Seller in an amount up to but not in excess of the Available Amount as of the end of such quarter. Any such request shall be valid only if it is in writing, is timely made, specifies the account of Seller to which such funds are to be transferred, and contains a certification of the Designated Representative that the requested amount does not exceed the Available Amount as of the end of the applicable quarter. Purchaser shall provide such funds within sixty (60) days of its receipt of such request or, following any determination by the Director that the Director will be mandated by law to appoint a receiver for Seller if such funds are not received sooner, such shorter period as may be necessary to avoid such mandatory appointment of a receiver if reasonably practicable taking into consideration Purchaser's access to funds.

2.3. *Accelerated Draws on Commitment.* Immediately following any determination by the Director that the Director will be mandated by law to appoint a receiver for Seller prior to the Liquidation End Date unless Seller's capital is increased by an amount (the "Special Amount")

up to but not in excess of the then current Available Amount (computed based on a balance sheet of Seller prepared in accordance with GAAP that differs from the most recent balance sheet of Seller delivered in accordance with Section 5.9(a) or (b)) on a date that is prior to the date that funds will be available to Seller pursuant to Section 2.2, Conservator may, on behalf of Seller, request that Purchaser provide to Seller the Special Amount in immediately available funds. Any such request shall be valid only if it is in writing, is timely made, specifies the account of Seller to which such funds are to be transferred, and contains certifications of Conservator that (i) the requested amount does not exceed the Available Amount (including computations in reasonable detail and satisfactory to Purchaser of the then existing Deficiency Amount) and (ii) the requested amount is required to avoid the imminent mandatory appointment of a receiver for Seller. Purchaser shall provide such funds within thirty (30) days of its receipt of such request or, if reasonably practicable taking into consideration Purchaser's access to funds, any shorter period as may be necessary to avoid mandatory appointment of a receiver.

2.4. *Final Draw on Commitment.* Within fifteen (15) Business Days following the determination of the Deficiency Amount, if any, as of the Liquidation End Date (computed based on a balance sheet of Seller as of the Liquidation End Date prepared in accordance with GAAP), the Designated Representative may, on behalf of Seller, request that Purchaser provide immediately available funds to Seller in an amount up to but not in excess of the Available Amount as of the Liquidation End Date. Any such request shall be valid only if it is in writing, is timely made, specifies the account of Seller to which such funds are to be transferred, and contains a certification of the Designated Representative that the requested amount does not exceed the Available Amount (including computations in reasonable detail and satisfactory to Purchaser of the Deficiency Amount as of the Liquidation End Date). Purchaser shall provide such funds within sixty (60) days of its receipt of such request.

2.5. *Termination of Purchaser's Obligations*. Subject to earlier termination pursuant to Section 6.7, all of Purchaser's obligations under and in respect of the Commitment shall terminate upon the earliest of: (a) if the Liquidation End Date shall have occurred, (i) the payment in full of Purchaser's obligations with respect to any valid request for funds pursuant to Section 2.4 or (ii) if there is no Deficiency Amount on the Liquidation End Date or if no such request pursuant to Section 2.4 has been made, the close of business on the 15th Business Day following the determination of the Deficiency Amount, if any, as of the Liquidation End Date; (b) the payment in full of, defeasance of or other reasonable provision for all liabilities of Seller, whether or not contingent, including payment of any amounts that may become payable on, or expiry of or other provision for, all Mortgage Guarantee Obligations and provision for unmatured debts; and (c) the funding by Purchaser under the Commitment of an aggregate of $100,000,000,000 (one hundred billion dollars). For the avoidance of doubt, the Commitment shall *not* be terminable by Purchaser solely by reason of (i) the conservatorship, receivership or other insolvency proceeding of Seller or (ii) the Seller's financial condition or any adverse change in Seller's financial condition.

3. PURCHASE OF SENIOR PREFERRED STOCK AND WARRANT; FEES

3.1. *Initial Commitment Fee.* In consideration of the Commitment, and for no additional consideration, on the Effective Date (or as soon thereafter as is practicable) Seller shall sell and issue to Purchaser, and Purchaser shall purchase from Seller, (a) one million (1,000,000) shares of Senior Preferred Stock, with an initial liquidation preference equal to $1,000 per share

($1,000,000,000 (one billion dollars) liquidation preference in the aggregate), and (b) the Warrant.

3.2. *Periodic Commitment Fee.* (a) Commencing March 31, 2010, Seller shall pay to Purchaser quarterly, on the last day of March, June, September and December of each calendar year (each a "Periodic Fee Date"), a periodic commitment fee (the "Periodic Commitment Fee"). The Periodic Commitment Fee shall accrue from January 1, 2010.

(b) The Periodic Commitment Fee is intended to fully compensate Purchaser for the support provided by the ongoing Commitment following December 31, 2009. The amount of the Periodic Commitment Fee shall be set not later than December 31, 2009 with respect to the ensuing five-year period, shall be reset every five years thereafter and shall be determined with reference to the market value of the Commitment as then in effect. The amount of the Periodic Commitment Fee shall be mutually agreed by Purchaser and Seller, subject to their reasonable discretion and in consultation with the Chairman of the Federal Reserve; provided, that Purchaser may waive the Periodic Commitment Fee for up to one year at a time, in its sole discretion, based on adverse conditions in the United States mortgage market.

(c) At the election of Seller, the Periodic Commitment Fee may be paid in cash or by adding the amount thereof ratably to the liquidation preference of each outstanding share of Senior Preferred Stock so that the aggregate liquidation preference of all such outstanding shares of Senior Preferred Stock is increased by an amount equal to the Periodic Commitment Fee. Seller shall deliver notice of such election not later than three (3) Business Days prior to each Periodic Fee Date. If the Periodic Commitment Fee is not paid in cash by 12:00 pm (New York time) on the applicable Periodic Fee Date (irrespective of Seller's election pursuant to this subsection), Seller shall be deemed to have elected to pay the Periodic Commitment Fee by adding the amount thereof to the liquidation preference of the Senior Preferred Stock, and the aggregate liquidation preference of the outstanding shares of Senior Preferred Stock shall thereupon be automatically increased, in the manner contemplated by the first sentence of this section, by an aggregate amount equal to the Periodic Commitment Fee then due.

3.3. *Increases of Senior Preferred Stock Liquidation Preference as a Result of Funding under the Commitment.* The aggregate liquidation preference of the outstanding shares of Senior Preferred Stock shall be automatically increased by an amount equal to the amount of each draw on the Commitment pursuant to Article 2 that is funded by Purchaser to Seller, such increase to occur simultaneously with such funding and ratably with respect to each share of Senior Preferred Stock.

3.4. *Notation of Increase in Liquidation Preference.* Seller shall duly mark its records to reflect each increase in the liquidation preference of the Senior Preferred Stock contemplated herein (but, for the avoidance of doubt, such increase shall be effective regardless of whether Seller has properly marked its records).

4. REPRESENTATIONS

Seller represents and warrants as of the Effective Date, and shall be deemed to have represented and warranted as of the date of each request for and funding of an advance under the Commitment pursuant to Article 2, as follows:

4.1. *Organization and Good Standing.* Seller is a corporation, chartered by the Congress of the United States, duly organized, validly existing and in good standing under the laws of the United States and has all corporate power and authority to carry on its business as now conducted and as proposed to be conducted.

4.2. *Organizational Documents.* Seller has made available to Purchaser a complete and correct copy of its charter and bylaws, each as amended to date (the "Organizational Documents"). The Organizational Documents are in full force and effect. Seller is not in violation of any provision of its Organizational Documents.

4.3. *Authorization and Enforceability.* All corporate or other action on the part of Seller or Conservator necessary for the authorization, execution, delivery and performance of this Agreement by Seller and for the authorization, issuance and delivery of the Senior Preferred Stock and the Warrant being purchased under this Agreement, has been taken. This Agreement has been duly and validly executed and delivered by Seller and (assuming due authorization, execution and delivery by the Purchaser) shall constitute the valid and legally binding obligation of Seller, enforceable against Seller in accordance with its terms, except to the extent the enforceability thereof may be limited by bankruptcy laws, insolvency laws, reorganization laws, moratorium laws or other laws of general applicability affecting creditors' rights generally or by general equitable principles (regardless of whether enforcement is sought in a proceeding in equity or at law). The Agency is acting as conservator for Seller under Section 1367 of the FHE Act. The Board of Directors of Seller, by valid action at a duly called meeting of the Board of Directors on September 6, 2008, consented to the appointment of the Agency as conservator for purposes of Section 1367(a)(3)(I) of the FHE Act, and the Director of the Agency has appointed the Agency as Conservator for Seller pursuant to Section 1367(a)(1) of the FHE Act, and each such action has not been rescinded, revoked or modified in any respect.

4.4. *Valid Issuance.* When issued in accordance with the terms of this Agreement, the Senior Preferred Stock and the Warrant will be duly authorized, validly issued, fully paid and nonassessable, free and clear of all liens and preemptive rights. The shares of common stock to which the holder of the Warrant is entitled have been duly and validly reserved for issuance. When issued and delivered in accordance with the terms of this Agreement and the Warrant, such shares will be duly authorized, validly issued, fully paid and nonassessable, free and clear of all liens and preemptive rights.

4.5. *Non-Contravention.*

(a) The execution, delivery or performance by Seller of this Agreement and the consummation by Seller of the transactions contemplated hereby do not and will not (i) conflict with or violate any provision of the Organizational Documents of Seller; (ii) conflict with or violate

any law, decree or regulation applicable to Seller or by which any property or asset of Seller is bound or affected, or (iii) result in any breach of, or constitute a default (with or without notice or lapse of time, or both) under, or give to others any right of termination, amendment, acceleration or cancellation of, or result in the creation of a lien upon any of the properties or assets of Seller, pursuant to any note, bond, mortgage, indenture or credit agreement, or any other contract, agreement, lease, license, permit, franchise or other instrument or obligation to which Seller is a party or by which Seller is bound or affected, other than, in the case of clause (iii), any such breach, default, termination, amendment, acceleration, cancellation or lien that would not have and would not reasonably be expected to have, individually or in the aggregate, a material adverse effect on the business, property, operations or condition of the Seller, the authority of the Conservator or the validity or enforceability of this Agreement (a "Material Adverse Effect").

(b) The execution and delivery of this Agreement by Seller does not, and the consummation by Seller of the transactions contemplated by this Agreement will not, require any consent, approval, authorization, waiver or permit of, or filing with or notification to, any governmental authority or any other person, except for such as have already been obtained.

5. COVENANTS

From the Effective Date until such time as the Senior Preferred Stock shall have been repaid or redeemed in full in accordance with its terms:

5.1. *Restricted Payments*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, declare or pay any dividend (preferred or otherwise) or make any other distribution (by reduction of capital or otherwise), whether in cash, property, securities or a combination thereof, with respect to any of Seller's Equity Interests (other than with respect to the Senior Preferred Stock or the Warrant) or directly or indirectly redeem, purchase, retire or otherwise acquire for value any of Seller's Equity Interests (other than the Senior Preferred Stock or the Warrant), or set aside any amount for any such purpose.

5.2. *Issuance of Capital Stock*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, sell or issue Equity Interests of Seller or any of its subsidiaries of any kind or nature, in any amount, other than the sale and issuance of the Senior Preferred Stock and Warrant on the Effective Date and the common stock subject to the Warrant upon exercise thereof, and other than as required by (and pursuant to) the terms of any binding agreement as in effect on the date hereof.

5.3. *Conservatorship*. Seller shall not (and Conservator, by its signature below, agrees that it shall not), without the prior written consent of Purchaser, terminate, seek termination of or permit to be terminated the conservatorship of Seller pursuant to Section 1367 of the FHE Act, other than in connection with a receivership pursuant to Section 1367 of the FHE Act.

5.4. *Transfer of Assets*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, sell, transfer, lease or otherwise dispose of (in one transaction or a series of related transactions) all or any portion of its assets (including

Equity Interests in other persons, including subsidiaries), whether now owned or hereafter acquired (any such sale, transfer, lease or disposition, a "Disposition"), other than Dispositions for fair market value:

(a) to a limited life regulated entity ("LLRE") pursuant to Section 1367(i) of the FHE Act;

(b) of assets and properties in the ordinary course of business, consistent with past practice;

(c) in connection with a liquidation of Seller by a receiver appointed pursuant to Section 1367(a) of the FHE Act;

(d) of cash or cash equivalents for cash or cash equivalents; or

(e) to the extent necessary to comply with the covenant set forth in Section 5.7 below.

5.5. *Indebtedness*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, incur, assume or otherwise become liable for (a) any Indebtedness if, after giving effect to the incurrence thereof, the aggregate Indebtedness of Seller and its subsidiaries on a consolidated basis would exceed 110.0% of the aggregate Indebtedness of Seller and its subsidiaries on a consolidated basis as of June 30, 2008 or (b) any Indebtedness if such Indebtedness is subordinated by its terms to any other Indebtedness of Seller or the applicable subsidiary. For purposes of this covenant the acquisition of a subsidiary with Indebtedness will be deemed to be the incurrence of such Indebtedness at the time of such acquisition.

5.6. *Fundamental Changes*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, (i) merge into or consolidate or amalgamate with any other Person, or permit any other Person to merge into or consolidate or amalgamate with it, (ii) effect a reorganization or recapitalization involving the common stock of Seller, a reclassification of the common stock of Seller or similar corporate transaction or event or (iii) purchase, lease or otherwise acquire (in one transaction or a series of transactions) all or substantially all of the assets of any other Person or any division, unit or business of any Person.

5.7. *Mortgage Assets*. Seller shall not own, as of any applicable date, Mortgage Assets in excess of (i) on December 31, 2009, $850 billion, or (ii) on December 31 of each year thereafter, 90.0% of the aggregate amount of Mortgage Assets of Seller as of December 31 of the immediately preceding calendar year; provided, that in no event shall Seller be required under this Section 5.7 to own less than $250 billion in Mortgage Assets.

5.8. *Transactions with Affiliates*. Seller shall not, and shall not permit any of its subsidiaries to, without the prior written consent of Purchaser, engage in any transaction of any kind or nature with an Affiliate of Seller unless such transaction is (i) pursuant to this Agreement, the Senior Preferred Stock or the Warrant, (ii) upon terms no less favorable to Seller than would be obtained in a comparable arm's-length transaction with a Person that is not an Affiliate of Seller or

(iii) a transaction undertaken in the ordinary course or pursuant to a contractual obligation or customary employment arrangement in existence as of the date hereof.

5.9. *Reporting*. Seller shall provide to Purchaser:

(a) not later than the time period specified in the SEC's rules and regulations with respect to issuers as to which Section 13 and 15(d) of the Exchange Act apply, annual reports on Form 10-K (or any successor or comparable form) containing the information required to be contained therein (or required in such successor or comparable form);

(b) not later than the time period specified in the SEC's rules and regulations with respect to issuers as to which Section 13 and 15(d) of the Exchange Act apply, reports on Form 10-Q (or any successor or comparable form) containing the information required to be contained therein (or required in such successor or comparable form);

(c) promptly from time to time after the occurrence of an event required to be therein reported (and in any event within the time period specified in the SEC's rules and regulations), such other reports on Form 8-K (or any successor or comparable form);

(d) concurrently with any delivery of financial statements under paragraphs (a) or (b) above, a certificate of the Designated Representative, (i) certifying that Seller is (and since the last such certificate has at all times been) in compliance with each of the covenants contained herein and that no representation made by Seller herein or in any document delivered pursuant hereto or in connection herewith was false or misleading in any material respect when made, or, if the foregoing is not true, specifying the nature and extent of the breach of covenant and/or representation and any corrective action taken or proposed to be taken with respect thereto, and (ii) setting forth computations in reasonable detail and satisfactory to the Purchaser of the Deficiency Amount, if any;

(e) promptly, from time to time, such other information regarding the operations, business affairs, plans, projections and financial condition of Seller, or compliance with the terms of this Agreement, as Purchaser may reasonably request; and

(f) as promptly as reasonably practicable, written notice of the following:

(i) the occurrence of the Liquidation End Date;

(ii) the filing or commencement of, or any written threat or notice of intention of any Person to file or commence, any action, suit or proceeding, whether at law or in equity or by or before any governmental authority or in arbitration, against Conservator, Seller or any other Person which, if adversely determined, would reasonably be expected to have a Material Adverse Effect;

(iii) any other development that is not a matter of general public knowledge and that has had, or would reasonably be expected to have, a Material Adverse Effect.

5.10. *Executive Compensation*. Seller shall not, without the consent of the Director, in consultation with the Secretary of the Treasury, enter into any new compensation arrangements with, or increase amounts or benefits payable under existing compensation arrangements of, any Named Executive Officer of Seller.

6. MISCELLANEOUS

6.1. *No Third-Party Beneficiaries*. Until the termination of the Commitment, at any time during the existence and continuance of a payment default with respect to debt securities issued by Seller and/or a default by Seller with respect to any Mortgage Guarantee Obligations, any holder of such defaulted debt securities or beneficiary of such Mortgage Guarantee Obligations (collectively, the "Holders") may (a) deliver notice to the Seller and the Designated Representative requesting exercise of all rights available to them under this Agreement to draw on the Commitment up to the lesser of the amount necessary to cure the outstanding payment defaults and the Available Amount as of the last day of the immediately preceding fiscal quarter, and (b) if Seller and the Designated Representative fail to act as requested within thirty (30) days of such notice, or if Purchaser shall fail to perform its obligations in respect of any draw on the Commitment and Seller and/or the Designated Representative shall not be diligently pursuing remedies in respect of such failure, seek judicial relief requiring Seller to draw on the Commitment or Purchaser to fund the Commitment, as applicable. The Holders shall have no other rights under or in respect of this Agreement, and the Commitment shall not otherwise be enforceable by any creditor of Seller or by any other Person other than the parties hereto, and no such creditor or other Person is intended to be, or shall be, a third party beneficiary of any provision of this Agreement.

6.2. *Non-Transferable; Successors*. The Commitment is solely for the benefit of Seller and shall not inure to the benefit of any other Person (other than the Holders to the extent set forth in Section 6.1), including any entity to which the charter of Seller may be transferred, to any LLRE or to any other successor to the assets, liabilities or operations of Seller. The Commitment may not be assigned or otherwise transferred, in whole or in part, to any Person (including, for the avoidance of doubt, any LLRE to which a receiver has assigned all or a portion of Seller's assets) without the prior written consent of Purchaser (which may be withheld in its sole discretion). In no event shall any successor to Seller (including such an LLRE) be entitled to the benefit of the Commitment without the prior written consent of Purchaser. Seller and Conservator, for themselves and on behalf of their permitted successors, covenant and agree not to transfer or purport to transfer the Commitment in contravention of the terms hereof, and any such attempted transfer shall be null and void *ab initio*. It is the expectation of the parties that, in the event Seller were placed into receivership and an LLRE formed to purchase certain of its assets and assume certain of its liabilities, the Commitment would remain with Seller for the benefit of the holders of the debt of Seller not assumed by the LLRE.

6.3. *Amendments; Waivers*. This Agreement may be waived or amended solely by a writing executed by both of the parties hereto, and, with respect to amendments to or waivers of the provisions of Sections 5.3, 6.2 and 6.11, the Conservator; provided, however, that no such waiver or amendment shall decrease the aggregate Commitment or add conditions to funding the amounts required to be funded by Purchaser under the Commitment if such waiver or amendment would,

in the reasonable opinion of Seller, adversely affect in any material respect the holders of debt securities of Seller and/or the beneficiaries of Mortgage Guarantee Obligations, in each case in their capacities as such, after taking into account any alternative arrangements that may be implemented concurrently with such waiver or amendment. In no event shall any rights granted hereunder prevent the parties hereto from waiving or amending in any manner whatsoever the covenants of Seller hereunder.

6.4. *Governing Law; Jurisdiction; Venue.* This Agreement and the Warrant shall be governed by, and construed in accordance with, the federal law of the United States of America if and to the extent such federal law is applicable, and otherwise in accordance with the laws of the State of New York. The Senior Preferred Stock shall be governed as set forth in the terms thereof. The United States District Court for the District of Columbia shall have exclusive jurisdiction over all civil actions arising out of this Agreement, the Commitment, the Senior Preferred Stock and the Warrant, and venue for any such civil action shall lie exclusively in the United States District Court for the District of Columbia.

6.5. *Notices.* Any notices delivered pursuant to or in connection with this Agreement shall be delivered to the applicable parties at the addresses set forth below:

If to Seller:

Federal National Mortgage Association
c/o Federal Housing Finance Authority
1700 G Street, NW
4th Floor
Washington, DC 20552
Attention: General Counsel

If to Purchaser:

United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington DC 20220
Attention: Under Secretary for Domestic Finance

with a copy to:

United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington DC 20220
Attention: General Counsel

If to Conservator:

Federal Housing Finance Authority
1700 G Street, NW

4th Floor
Washington, DC 20552
Attention: General Counsel

All notices and other communications provided for herein shall be in writing and shall be delivered by hand or overnight courier service, mailed by certified or registered mail. All notices hereunder shall be effective upon receipt.

6.6. *Disclaimer of Guarantee*. This Agreement and the Commitment are not intended to and shall not be deemed to constitute a guarantee by Purchaser or any other agency or instrumentality of the United States of the payment or performance of any debt security or any other obligation, indebtedness or liability of Seller of any kind or character whatsoever.

6.7. *Effect of Order; Injunction; Decree*. If any order, injunction or decree is issued by any court of competent jurisdiction that vacates, modifies, amends, conditions, enjoins, stays or otherwise affects the appointment of Conservator as conservator of Seller or otherwise curtails Conservator's powers as such conservator (except in each case any order converting the conservatorship to a receivership under Section 1367(a) of the FHE Act), Purchaser may by written notice to Conservator and Seller declare this Agreement null and void, whereupon all transfers hereunder (including the issuance of the Senior Preferred Stock and the Warrant and any funding of the Commitment) shall be rescinded and unwound and all obligations of the parties (other than to effectuate such rescission and unwind) shall immediately and automatically terminate.

6.8. *Business Day*. To the extent that any deadline or date of performance of any right or obligation set forth herein shall fall on a day other than a Business Day, then such deadline or date of performance shall automatically be extended to the next succeeding Business Day.

6.9. *Entire Agreement*. This Agreement, together with the Senior Preferred Stock and Warrant, contains the entire agreement between the parties hereto with respect to the transactions contemplated hereby and supersedes and cancels all prior agreements, including, but not limited to, all proposals, term sheets, statements, letters of intent or representations, written or oral, with respect thereto.

6.10. *Remedies*. In the event of a breach by Seller of any covenant or representation of Seller set forth herein, Purchaser shall be entitled to specific performance (in the case of a breach of covenant), damages and such other remedies as may be available at law or in equity; provided, that Purchaser shall not have the right to terminate the Commitment solely as a result of any such breach, and compliance with the covenants and the accuracy of the representations set forth in this Agreement shall not be conditions to funding the Commitment.

6.11. *Tax Reporting*. Neither Seller nor Conservator shall take, or shall permit any of their respective successors or assigns to take, a position for any tax, accounting or other purpose that is inconsistent with Internal Revenue Service Notice 2008-76 (or the regulations to be issued pursuant to such Notice) regarding the application of Section 382 of the Internal Revenue Code of 1986, as amended, a copy of which Notice has been provided to Seller in connection with the execution of this Agreement.

6.12. *Non-Severability*. Each of the provisions of this Agreement is integrated with and integral to the whole and shall not be severable from the remainder of the Agreement. In the event that any provision of this Agreement, the Senior Preferred Stock or the Warrant is determined to be illegal or unenforceable, then Purchaser may, in its sole discretion, by written notice to Conservator and Seller, declare this Agreement null and void, whereupon all transfers hereunder (including the issuance of the Senior Preferred Stock and the Warrant and any funding of the Commitment) shall be rescinded and unwound and all obligations of the parties (other than to effectuate such rescission and unwind) shall immediately and automatically terminate.

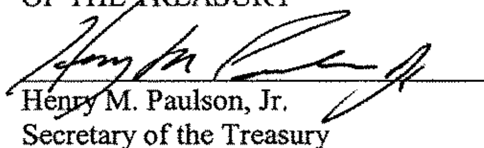
[Signature Page Follows]

FEDERAL NATIONAL MORTGAGE
ASSOCIATION, by

Federal Housing Finance Agency,
its Conservator

James B. Lockhart III
Director

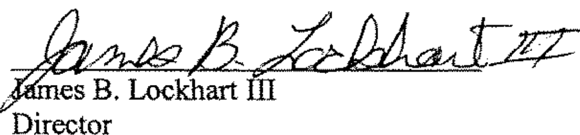
UNITED STATES DEPARTMENT
OF THE TREASURY



Henry M. Paulson, Jr.
Secretary of the Treasury

Acknowledged and, solely as
to Sections 5.3, 6.2 and 6.11,
agreed:

FEDERAL HOUSING
FINANCE AGENCY,
as Conservator



James B. Lockhart III
Director

CERTIFICATE OF DESIGNATION OF TERMS OF VARIABLE LIQUIDATION PREFERENCE SENIOR PREFERRED STOCK, SERIES 2008-2

1. Designation, Par Value, Number of Shares and Priority

The designation of the series of preferred stock of the Federal National Mortgage Association (the "Company") created by this resolution shall be "Variable Liquidation Preference Senior Preferred Stock, Series 2008-2" (the "Senior Preferred Stock"), and the number of shares initially constituting the Senior Preferred Stock is 1,000,000. Shares of Senior Preferred Stock will have no par value and a stated value and initial liquidation preference per share equal to $1,000 per share, subject to adjustment as set forth herein. The Board of Directors of the Company, or a duly authorized committee thereof, in its sole discretion, may reduce the number of shares of Senior Preferred Stock, provided such reduction is not below the number of shares of Senior Preferred Stock then outstanding.

The Senior Preferred Stock shall rank prior to the common stock of the Company as provided in this Certificate and shall rank, as to both dividends and distributions upon dissolution, liquidation or winding up of the Company, prior to (a) the shares of preferred stock of the Company designated "5.25% Non-Cumulative Preferred Stock, Series D", "5.10% Non-Cumulative Preferred Stock, Series E", "Variable Rate Non-Cumulative Preferred Stock, Series F", "Variable Rate Non-Cumulative Preferred Stock, Series G", "5.81% Non-Cumulative Preferred Stock, Series H", "5.375% Non-Cumulative Preferred Stock, Series I", "5.125% Non-Cumulative Preferred Stock, Series L", "4.75% Non-Cumulative Preferred Stock, Series M", "5.50% Non-Cumulative Preferred Stock, Series N", "Non-Cumulative Preferred Stock, Series O", "Non-Cumulative Convertible Series 2004-1 Preferred Stock", "Variable Rate Non-Cumulative Preferred Stock, Series P", "6.75% Non-Cumulative Preferred Stock, Series Q", "7.625% Non-Cumulative Preferred Stock, Series R", "Fixed-to-Floating Rate Non-Cumulative Preferred Stock, Series S", and "8.75% Non-Cumulative Mandatory Convertible Preferred Stock", Series 2008-1", (b) any other capital stock of the Company outstanding on the date of the initial issuance of the Senior Preferred Stock and (c) any capital stock of the Company that may be issued after the date of initial issuance of the Senior Preferred Stock.

2. Dividends

(a) For each Dividend Period from the date of the initial issuance of the Senior Preferred Stock, holders of outstanding shares of Senior Preferred Stock shall be entitled to receive, ratably, when, as and if declared by the Board of Directors, in its sole discretion, out of funds legally available therefor, cumulative cash dividends at the annual rate per share equal to the then-current Dividend Rate on the then-current Liquidation Preference. Dividends on the Senior Preferred Stock shall accrue from but not including the date of the initial issuance of the Senior Preferred Stock and will be payable in arrears when, as and if declared by the Board of Directors quarterly on March 31, June 30, September 30 and December 31 of each year (each, a "Dividend Payment Date"), commencing on December 31, 2008. If a Dividend Payment Date is not a "Business Day," the related dividend will be paid not later than the next Business Day with the same force and effect as though paid on the Dividend Payment Date, without any increase to

account for the period from such Dividend Payment Date through the date of actual payment. "Business Day" means a day other than (i) a Saturday or Sunday, (ii) a day on which New York City banks are closed, or (iii) a day on which the offices of the Company are closed.

If declared, the initial dividend will be for the period from but not including the date of the initial issuance of the Senior Preferred Stock through and including December 31, 2008. Except for the initial Dividend Payment Date, the "Dividend Period" relating to a Dividend Payment Date will be the period from but not including the preceding Dividend Payment Date through and including the related Dividend Payment Date. The amount of dividends payable on the initial Dividend Payment Date or for any Dividend Period that is not a full calendar quarter shall be computed on the basis of 30-day months, a 360-day year and the actual number of days elapsed in any period of less than one month. For the avoidance of doubt, in the event that the Liquidation Preference changes in the middle of a Dividend Period, the amount of dividends payable on the Dividend Payment Date at the end of such Dividend Period shall take into account such change in Liquidation Preference and shall be computed at the Dividend Rate on each Liquidation Preference based on the portion of the Dividend Period that each Liquidation Preference was in effect.

(b) To the extent not paid pursuant to Section 2(a) above, dividends on the Senior Preferred Stock shall accrue and shall be added to the Liquidation Preference pursuant to Section 8, whether or not there are funds legally available for the payment of such dividends and whether or not dividends are declared.

(c) "Dividend Rate" means 10.0%; provided, however, that if at any time the Company shall have for any reason failed to pay dividends in cash in a timely manner as required by this Certificate, then immediately following such failure and for all Dividend Periods thereafter until the Dividend Period following the date on which the Company shall have paid in cash full cumulative dividends (including any unpaid dividends added to the Liquidation Preference pursuant to Section 8), the "Dividend Rate" shall mean 12.0%.

(d) Each such dividend shall be paid to the holders of record of outstanding shares of the Senior Preferred Stock as they appear in the books and records of the Company on such record date as shall be fixed in advance by the Board of Directors, not to be earlier than 45 days nor later than 10 days preceding the applicable Dividend Payment Date. The Company may not, at any time, declare or pay dividends on, make distributions with respect to, or redeem, purchase or acquire, or make a liquidation payment with respect to, any common stock or other securities ranking junior to the Senior Preferred Stock unless (i) full cumulative dividends on the outstanding Senior Preferred Stock in respect of the then-current Dividend Period and all past Dividend Periods (including any unpaid dividends added to the Liquidation Preference pursuant to Section 8) have been declared and paid in cash (including through any pay down of Liquidation Preference pursuant to Section 3) and (ii) all amounts required to be paid pursuant to Section 4 (without giving effect to any prohibition on such payment under any applicable law) have been paid in cash.

(e) Notwithstanding any other provision of this Certificate, the Board of Directors, in its discretion, may choose to pay dividends on the Senior Preferred Stock without the payment of any dividends on the common stock, preferred stock or any other class or series of stock from time

to time outstanding ranking junior to the Senior Preferred Stock with respect to the payment of dividends.

(f) If and whenever dividends, having been declared, shall not have been paid in full, as aforesaid, on shares of the Senior Preferred Stock, all such dividends that have been declared on shares of the Senior Preferred Stock shall be paid to the holders pro rata based on the aggregate Liquidation Preference of the shares of Senior Preferred Stock held by each holder, and any amounts due but not paid in cash shall be added to the Liquidation Preference pursuant to Section 8.

3. Optional Pay Down of Liquidation Preference

(a) Following termination of the Commitment (as defined in the Preferred Stock Purchase Agreement referred to in Section 8 below), and subject to any limitations which may be imposed by law and the provisions below, the Company may pay down the Liquidation Preference of all outstanding shares of the Senior Preferred Stock pro rata, at any time, in whole or in part, out of funds legally available therefor, with such payment first being used to reduce any accrued and unpaid dividends previously added to the Liquidation Preference pursuant to Section 8 below and, to the extent all such accrued and unpaid dividends have been paid, next being used to reduce any Periodic Commitment Fees (as defined in the Preferred Stock Purchase Agreement referred to in Section 8 below) previously added to the Liquidation Preference pursuant to Section 8 below. Prior to termination of the Commitment, and subject to any limitations which may be imposed by law and the provisions below, the Company may pay down the Liquidation Preference of all outstanding shares of the Senior Preferred Stock pro rata, at any time, out of funds legally available therefor, but only to the extent of (i) accrued and unpaid dividends previously added to the Liquidation Preference pursuant to Section 8 below and not repaid by any prior pay down of Liquidation Preference and (ii) Periodic Commitment Fees previously added to the Liquidation Preference pursuant to Section 8 below and not repaid by any prior pay down of Liquidation Preference. Any pay down of Liquidation Preference permitted by this Section 3 shall be paid by making a payment in cash to the holders of record of outstanding shares of the Senior Preferred Stock as they appear in the books and records of the Company on such record date as shall be fixed in advance by the Board of Directors, not to be earlier than 45 days nor later than 10 days preceding the date fixed for the payment.

(b) In the event the Company shall pay down of the Liquidation Preference of the Senior Preferred Stock as aforesaid, notice of such pay down shall be given by the Company by first class mail, postage prepaid, mailed neither less than 10 nor more than 45 days preceding the date fixed for the payment, to each holder of record of the shares of the Senior Preferred Stock, at such holder's address as the same appears in the books and records of the Company. Each such notice shall state the amount by which the Liquidation Preference of each share shall be reduced and the pay down date.

(c) If after termination of the Commitment the Company pays down the Liquidation Preference of each outstanding share of Senior Preferred Stock in full, such shares shall be deemed to have been redeemed as of the date of such payment, and the dividend that would otherwise be payable for the Dividend Period ending on the pay down date will be paid on such date. Following such deemed redemption, the shares of the Senior Preferred Stock shall no longer be deemed to be

outstanding, and all rights of the holders thereof as holders of the Senior Preferred Stock shall cease, with respect to shares so redeemed, other than the right to receive the pay down amount (which shall include the final dividend for such shares). Any shares of the Senior Preferred Stock which shall have been so redeemed, after such redemption, shall no longer have the status of authorized, issued or outstanding shares.

4. Mandatory Pay Down of Liquidation Preference Upon Issuance of Capital Stock

(a) If the Company shall issue any shares of capital stock (including without limitation common stock or any series of preferred stock) in exchange for cash at any time while the Senior Preferred Stock is outstanding, then the Company shall, within 10 Business Days, use the proceeds of such issuance net of the direct costs relating to the issuance of such securities (including, without limitation, legal, accounting and investment banking fees) to pay down the Liquidation Preference of all outstanding shares of Senior Preferred Stock pro rata, out of funds legally available therefor, by making a payment in cash to the holders of record of outstanding shares of the Senior Preferred Stock as they appear in the books and records of the Company on such record date as shall be fixed in advance by the Board of Directors, not to be earlier than 45 days nor later than 10 days preceding the date fixed for the payment, with such payment first being used to reduce any accrued and unpaid dividends previously added to the Liquidation Preference pursuant to Section 8 below and, to the extent all such accrued and unpaid dividends have been paid, next being used to reduce any Periodic Commitment Fees (as defined in the Preferred Stock Purchase Agreement referred to in Section 8 below) previously added to the Liquidation Preference pursuant to Section 8 below; provided that, prior to the termination of the Commitment (as defined in the Preferred Stock Purchase Agreement referred to in Section 8 below), the Liquidation Preference of each share of Senior Preferred Stock shall not be paid down below $1,000 per share.

(b) If the Company shall not have sufficient assets legally available for the pay down of the Liquidation Preference of the shares of Senior Preferred Stock required under Section 4(a), the Company shall pay down the Liquidation Preference per share to the extent permitted by law, and shall pay down any Liquidation Preference not so paid down because of the unavailability of legally available assets or other prohibition as soon as practicable to the extent it is thereafter able to make such pay down legally. The inability of the Company to make such payment for any reason shall not relieve the Company from its obligation to effect any required pay down of the Liquidation Preference when, as and if permitted by law.

(c) If after the termination of the Commitment the Company pays down the Liquidation Preference of each outstanding share of Senior Preferred Stock in full, such shares shall be deemed to have been redeemed as of the date of such payment, and the dividend that would otherwise be payable for the Dividend Period ending on the pay down date will be paid on such date. Following such deemed redemption, the shares of the Senior Preferred Stock shall no longer be deemed to be outstanding, and all rights of the holders thereof as holders of the Senior Preferred Stock shall cease, with respect to shares so redeemed, other than the right to receive the pay down amount (which shall include the final dividend for such redeemed shares). Any shares of the Senior Preferred Stock which shall have been so redeemed, after such redemption, shall no longer have the status of authorized, issued or outstanding shares.

5. No Voting Rights

Except as set forth in this Certificate or otherwise required by law, the shares of the Senior Preferred Stock shall not have any voting powers, either general or special.

6. No Conversion or Exchange Rights

The holders of shares of the Senior Preferred Stock shall not have any right to convert such shares into or exchange such shares for any other class or series of stock or obligations of the Company.

7. No Preemptive Rights

No holder of the Senior Preferred Stock shall as such holder have any preemptive right to purchase or subscribe for any other shares, rights, options or other securities of any class of the Company which at any time may be sold or offered for sale by the Company.

8. Liquidation Rights and Preference

(a) Except as otherwise set forth herein, upon the voluntary or involuntary dissolution, liquidation or winding up of the Company, the holders of the outstanding shares of the Senior Preferred Stock shall be entitled to receive out of the assets of the Company available for distribution to stockholders, before any payment or distribution shall be made on the common stock or any other class or series of stock of the Company ranking junior to the Senior Preferred Stock upon liquidation, the amount per share equal to the Liquidation Preference plus an amount, determined in accordance with Section 2(a) above, equal to the dividend otherwise payable for the then-current Dividend Period accrued through and including the date of payment in respect of such dissolution, liquidation or winding up; provided, however, that if the assets of the Company available for distribution to stockholders shall be insufficient for the payment of the amount which the holders of the outstanding shares of the Senior Preferred Stock shall be entitled to receive upon such dissolution, liquidation or winding up of the Company as aforesaid, then, all of the assets of the Company available for distribution to stockholders shall be distributed to the holders of outstanding shares of the Senior Preferred Stock pro rata based on the aggregate Liquidation Preference of the shares of Senior Preferred Stock held by each holder.

(b) "Liquidation Preference" shall initially mean $1,000 per share and shall be:

(i) increased each time a Deficiency Amount (as defined in the Preferred Stock Purchase Agreement) is paid to the Company by an amount per share equal to the aggregate amount so paid to the Company divided by the number of shares of Senior Preferred Stock outstanding at the time of such payment;

(ii) increased each time the Company does not pay the full Periodic Commitment Fee (as defined in the Preferred Stock Purchase Agreement) in cash by an amount per share equal to the amount of the Periodic Commitment Fee that is not paid in cash divided by the number of shares of Senior Preferred Stock outstanding at the time such payment is due;

(iii) increased on the Dividend Payment Date if the Company fails to pay in full the dividend payable for the Dividend Period ending on such date by an amount per share equal to the aggregate amount of unpaid dividends divided by the number of shares of Senior Preferred Stock outstanding on such date; and

(iv) decreased each time the Company pays down the Liquidation Preference pursuant to Section 3 or Section 4 of this Certificate by an amount per share equal to the aggregate amount of the pay down divided by the number of shares of Senior Preferred Stock outstanding at the time of such pay down.

(c) "Preferred Stock Purchase Agreement" means the Preferred Stock Purchase Agreement, dated September 7, 2008, between the Company and the United States Department of the Treasury.

(d) Neither the sale of all or substantially all of the property or business of the Company, nor the merger, consolidation or combination of the Company into or with any other corporation or entity, shall be deemed to be a dissolution, liquidation or winding up for the purpose of this Section 8.

9. Additional Classes or Series of Stock

The Board of Directors shall have the right at any time in the future to authorize, create and issue, by resolution or resolutions, one or more additional classes or series of stock of the Company, and to determine and fix the distinguishing characteristics and the relative rights, preferences, privileges and other terms of the shares thereof; provided that, any such class or series of stock may not rank prior to or on parity with the Senior Preferred Stock without the prior written consent of the holders of at least two-thirds of all the shares of Senior Preferred Stock at the time outstanding.

10. Miscellaneous

(a) The Company and any agent of the Company may deem and treat the holder of a share or shares of Senior Preferred Stock, as shown in the Company's books and records, as the absolute owner of such share or shares of Senior Preferred Stock for the purpose of receiving payment of dividends in respect of such share or shares of Senior Preferred Stock and for all other purposes whatsoever, and neither the Company nor any agent of the Company shall be affected by any notice to the contrary. All payments made to or upon the order of any such person shall be valid and, to the extent of the sum or sums so paid, effectual to satisfy and discharge liabilities for moneys payable by the Company on or with respect to any such share or shares of Senior Preferred Stock.

(b) The shares of the Senior Preferred Stock, when duly issued, shall be fully paid and non-assessable.

(c) The Senior Preferred Stock may be issued, and shall be transferable on the books of the Company, only in whole shares.

(d) For purposes of this Certificate, the term "the Company" means the Federal National Mortgage Association and any successor thereto by operation of law or by reason of a merger, consolidation, combination or similar transaction.

(e) This Certificate and the respective rights and obligations of the Company and the holders of the Senior Preferred Stock with respect to such Senior Preferred Stock shall be construed in accordance with and governed by the laws of the United States, provided that the law of the State of Delaware shall serve as the federal rule of decision in all instances except where such law is inconsistent with the Company's enabling legislation, its public purposes or any provision of this Certificate.

(f) Any notice, demand or other communication which by any provision of this Certificate is required or permitted to be given or served to or upon the Company shall be given or served in writing addressed (unless and until another address shall be published by the Company) to Fannie Mae, 3900 Wisconsin Avenue NW, Washington, DC 20016, Attn: Executive Vice President and General Counsel. Such notice, demand or other communication to or upon the Company shall be deemed to have been sufficiently given or made only upon actual receipt of a writing by the Company. Any notice, demand or other communication which by any provision of this Certificate is required or permitted to be given or served by the Company hereunder may be given or served by being deposited first class, postage prepaid, in the United States mail addressed (i) to the holder as such holder's name and address may appear at such time in the books and records of the Company or (ii) if to a person or entity other than a holder of record of the Senior Preferred Stock, to such person or entity at such address as reasonably appears to the Company to be appropriate at such time. Such notice, demand or other communication shall be deemed to have been sufficiently given or made, for all purposes, upon mailing.

(g) The Company, by or under the authority of the Board of Directors, may amend, alter, supplement or repeal any provision of this Certificate pursuant to the following terms and conditions:

(i) Without the consent of the holders of the Senior Preferred Stock, the Company may amend, alter, supplement or repeal any provision of this Certificate to cure any ambiguity, to correct or supplement any provision herein which may be defective or inconsistent with any other provision herein, or to make any other provisions with respect to matters or questions arising under this Certificate, provided that such action shall not adversely affect the interests of the holders of the Senior Preferred Stock.

(ii) The consent of the holders of at least two-thirds of all of the shares of the Senior Preferred Stock at the time outstanding, given in person or by proxy, either in writing or by a vote at a meeting called for the purpose at which the holders of shares of the Senior Preferred Stock shall vote together as a class, shall be necessary for authorizing, effecting or validating the amendment, alteration, supplementation or repeal (whether by merger, consolidation or otherwise) of the provisions of this Certificate other than as set forth in subparagraph (i) of this paragraph (g). The creation and issuance of any other class or series of stock, or the issuance of additional shares of any existing class or series of stock, of the Company ranking junior to the Senior Preferred Stock shall not be deemed to constitute such an amendment, alteration, supplementation or repeal.

(iii) Holders of the Senior Preferred Stock shall be entitled to one vote per share on matters on which their consent is required pursuant to subparagraph (ii) of this paragraph (g). In connection with any meeting of such holders, the Board of Directors shall fix a record date, neither earlier than 60 days nor later than 10 days prior to the date of such meeting, and holders of record of shares of the Senior Preferred Stock on such record date shall be entitled to notice of and to vote at any such meeting and any adjournment. The Board of Directors, or such person or persons as it may designate, may establish reasonable rules and procedures as to the solicitation of the consent of holders of the Senior Preferred Stock at any such meeting or otherwise, which rules and procedures shall conform to the requirements of any national securities exchange on which the Senior Preferred Stock may be listed at such time.

(h) **RECEIPT AND ACCEPTANCE OF A SHARE OR SHARES OF THE SENIOR PREFERRED STOCK BY OR ON BEHALF OF A HOLDER SHALL CONSTITUTE THE UNCONDITIONAL ACCEPTANCE BY THE HOLDER (AND ALL OTHERS HAVING BENEFICIAL OWNERSHIP OF SUCH SHARE OR SHARES) OF ALL OF THE TERMS AND PROVISIONS OF THIS CERTIFICATE. NO SIGNATURE OR OTHER FURTHER MANIFESTATION OF ASSENT TO THE TERMS AND PROVISIONS OF THIS CERTIFICATE SHALL BE NECESSARY FOR ITS OPERATION OR EFFECT AS BETWEEN THE COMPANY AND THE HOLDER (AND ALL SUCH OTHERS).**

IN WITNESS WHEREOF, I have hereunto set my hand and the seal of the Company this 7th day of September, 2008.

[Seal]

FEDERAL NATIONAL MORTGAGE ASSOCIATION,
by

The Federal Housing Finance Agency, its Conservator

____

James B. Lockhart III
Director

FEDERAL NATIONAL MORTGAGE ASSOCIATION
WARRANT TO PURCHASE COMMON STOCK

NO. _____ September 7, 2008

VOID AFTER SEPTEMBER 7, 2028

THIS CERTIFIES THAT, for value received, the United States Department of the Treasury, with its principal office at 1500 Pennsylvania Avenue, NW, Washington, DC 20220 (the "Holder"), is entitled to purchase at the Exercise Price (defined below) from Federal National Mortgage Association, a government-sponsored enterprise of the United States of America, with its principal office at 3900 Wisconsin Avenue, NW, Washington, DC 20016 (the "Company"), shares of common stock, no par value, of the Company, as provided herein.

1. Definitions. As used herein, the following terms shall have the following respective meanings:

"Affiliate" shall mean, as to any specified Person, any other Person directly or indirectly controlling or controlled by or under direct or indirect common control with such specified Person. For the purposes of this definition, "control," when used with respect to any Person, means the power to direct the management and policies of such Person, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise and the terms "affiliated," "controlling" and "controlled" have meanings correlative to the foregoing.

"Business Day" shall mean each Monday, Tuesday, Wednesday, Thursday and Friday that is not a day on which banking institutions in New York, New York are authorized or obligated by law or executive order to close.

"Common Stock" shall mean the common stock, no par value, of the Company, and all other stock of any class or classes (however designated) of the Company from time to time outstanding, the holders of which have the right, without limitation as to amount, either to all or to a share of the balance of current dividends or liquidating distributions after the payment of dividends and distributions on any shares entitled to preference.

"Exercise Period" shall mean the time period commencing with the date hereof and ending at 5:00 p.m. New York time on the 20th anniversary of the date hereof.

"Exercise Price" shall mean one one-thousandth of a cent ($0.00001) per share.

"Exercise Shares" shall mean the shares of the Common Stock issuable upon exercise of this Warrant, subject to adjustment pursuant to the terms herein, and shall also mean any other shares, securities, assets or property otherwise issuable upon exercise of this Warrant.

"Fair Market Value" shall mean, with respect to a share of Common Stock, or any other security of the Company or any other issuer:

(a) the volume weighted average daily Market Price during the period of the most recent twenty (20) Trading Days, ending on the last Trading Day before the date of determination of Fair Market Value, if such class of Common Stock or other security is (i) traded

on the New York Stock Exchange or any other U.S. national or regional securities exchange, or admitted to unlisted trading privileges on such an exchange, or (ii) is quoted or reported on the Over-the-Counter Bulletin Board ("OTCBB") or by Pink OTC Markets Inc. or a similar organization or agency succeeding to its functions of reporting prices; or

(b) if such class of Common Stock or other security is not then so listed, admitted to trading or quoted, the Fair Market Value shall be the Market Price on the last Business Day before the date of determination of Fair Market Value.

"Fully Diluted" shall mean, as of immediately prior to the exercise of this Warrant (or a portion of this Warrant), the sum of, without duplication, (i) the total number of shares of Common Stock outstanding and (ii) all shares of Common Stock issuable in respect of securities convertible into or exercisable or exchangeable for Common Stock, stock appreciation rights or options, warrants (including this Warrant) and other rights to purchase or subscribe for Common Stock or securities convertible into or exercisable or exchangeable for Common Stock (in each case, assuming that no restrictions apply with respect to conversion, exercise, exchange, subscription or purchase).

"Market Price" shall be, as of any specified date with respect to any share of any class of Common Stock or any other security of the Company or any other issuer:

(i) the closing price on that date or, if no closing price is reported, the last reported sale price, of shares of the Common Stock or such other security on the New York Stock Exchange on that date; or

(ii) if the Common Stock or such other security is not traded on the New York Stock Exchange, the closing price on that date as reported in composite transactions for the principal U.S. national or regional securities exchange on which the Common Stock or such other security is so traded or, if no closing price is reported, the last reported sale price of shares of the Common Stock or such other security on the principal U.S. national or regional securities exchange on which the Common Stock or such other security is so traded on that date; or

(iii) if the Common Stock or such other security is not traded on a U.S. national or regional securities exchange, the last quoted bid price on that date for the Common Stock or such other security in the over-the-counter market as reported (x) by the OTCBB or (y) if reports are unavailable under clause (x) above by Pink OTC Markets Inc. or a similar organization or agency succeeding to its functions of reporting prices;

(iv) if the Common Stock or such other security is not so quoted by OTCBB or Pink OTC Markets Inc. or a similar organization, the Market Price shall be determined in accordance with the Valuation Procedure.

"Participating Securities" shall mean, (i) any equity security (other than Common Stock) that entitles the holders thereof to participate in liquidations or other distributions with the holders of Common Stock or otherwise participate in the capital of the Company other than through a fixed or floating rate of return on capital loaned or invested, and (ii) any stock appreciation rights, phantom stock rights, or any other profit participation rights with respect to

any of the Company's capital stock or other equity ownership interest, or any rights or options to acquire any such rights.

"Person" shall mean any individual, corporation, limited liability company, partnership, joint venture, association, joint-stock company, trust, estate, unincorporated organization or government or any agency or political subdivision thereof, or any other entity whatsoever.

"Trading Day" shall mean, with respect to any class of Common Stock or any other security of the Company or any other issuer a day (i) on which the securities exchange or other trading platform applicable for purposes of determining the Market Price of a share or unit of such class of Common Stock or other security shall be open for business or (ii) for which quotations from such securities exchange or other trading platform of the character specified for purposes of determining such Market Price shall be reported.

"Valuation Procedure" shall mean a determination made in good faith by the Board of Directors of the Company (the "Board") that is set forth in resolutions of the Board that are certified by the Secretary of the Company, which certified resolutions (i) set forth the basis of the Board's determination, which, in the case of a valuation in excess of $100 million, shall include the Board's reliance on the valuation of a nationally recognized investment banking or appraisal firm, and (ii) are delivered to the Holder within ten (10) Business Days following such determination. A Valuation Procedure with respect to the value of any capital stock shall be based on the price that would be paid for all of the capital stock of the issuer in an arm's-length transaction between a willing buyer and a willing seller (neither acting under compulsion).

2. Exercise of Warrant; Number of Shares.

2.1 Exercise. This Warrant may be exercised in whole or in part at any time during the Exercise Period, by delivery of the following to the Company at its address set forth above (or at such other address as it may designate by notice in writing to the Holder):

(a) an executed Notice of Exercise in the form attached hereto;

(b) payment of the Exercise Price (i) in cash or by check, (ii) by cancellation of indebtedness or (iii) pursuant to Section 2.2 hereof; and

(c) this Warrant.

This Warrant will be exercisable for a number of shares of Common Stock that, together with the shares of Common Stock previously issued pursuant to this Warrant, is equal to 79.9% of the total number of shares of Common Stock outstanding on a Fully Diluted basis on the date of exercise. Whenever the Holder exercises this Warrant in whole or in part, it may assign its right to receive the Exercise Shares issuable upon such exercise to any other Person.

As soon as practicable (and in any event within five Business Days) after this Warrant shall have been exercised, a certificate or certificates for the Exercise Shares so purchased, registered in the name of the Holder or such other Person as may be designated by the Holder (to the extent such transfer is not validly restricted and upon payment of any transfer taxes that are

required to be paid by the Holder in connection with any such transfer), shall be issued and delivered by the Company to the Holder or such other Person .

The Person in whose name any certificate or certificates for the Exercise Shares are to be issued upon exercise of this Warrant shall be deemed to have become the holder of record of such shares on the date on which this Warrant was surrendered and payment of the Exercise Price was made, irrespective of the date of delivery of such certificate or certificates, except that, if the date of such surrender and payment is a date when the stock transfer books of the Company are closed, such Person shall be deemed to have become the holder of such shares at the close of business on the next succeeding date on which the stock transfer books are open (whether before or after the end of the Exercise Period).

2.2 Net Exercise. Notwithstanding any provision herein to the contrary, if the Market Price of one share of the Common Stock is greater than the Exercise Price (at the date of calculation as set forth below), in lieu of exercising this Warrant by payment of cash, check or cancellation of indebtedness, the Holder may elect (the "Conversion Right") to receive shares equal to the value (as determined below) of this Warrant (or the portion thereof being canceled) by surrender of this Warrant at the principal office of the Company together with the properly endorsed Notice of Exercise in which event the Company shall issue to the Holder a number of shares of Common Stock computed using the following formula:

$$X = \frac{Y\,(A-B)}{A}$$

Where X = the number of shares of Common Stock to be issued

Y = the number of shares of Common Stock purchasable under this Warrant or, if only a portion of this Warrant is being exercised, the portion of this Warrant being exercised (at the date of such calculation)

A = the Market Price of one share of the Common Stock (at the date of such calculation)

B = Exercise Price (as adjusted pursuant to the terms herein to the date of such calculation)

The Company shall pay all reasonable administrative costs incurred by the Holder in connection with the exercise of the Conversion Right by the Holder pursuant to this Section 2.2.

3. Covenants and Representations of the Company

3.1 Covenants as to Exercise Shares.

(a) The Company covenants and agrees that all Exercise Shares that may be issued upon the exercise of this Warrant will, upon issuance, be validly authorized, issued and outstanding, fully paid and nonassessable, free of preemptive rights and free from all taxes, liens and charges with respect to the issuance thereof. If the Common Stock or the class of securities of any other Exercise Shares is then listed or quoted on a national securities exchange

or a regional securities exchange, all such Exercise Shares shall, upon issuance, also be so listed or quoted. The Company further covenants and agrees that the Company will at all times during the Exercise Period, have authorized and reserved solely for purposes of the exercise of this Warrant, free from preemptive rights, a sufficient number of shares of its Common Stock or the class of securities of any other Exercise Shares to provide for the exercise in full of this Warrant (without taking into account any possible exercise pursuant to Section 2.2 hereof). If at any time during the Exercise Period the number of authorized but unissued shares of Common Stock or the class of securities of any other Exercise Shares shall not be sufficient to permit exercise in full of this Warrant (without taking into account any possible exercise pursuant to Section 2.2 hereof), the Company will take such corporate action as shall be necessary to increase its authorized but unissued shares of Common Stock or the class of securities of any other Exercise Shares to such number of shares as shall be sufficient for such purposes.

(b) If at any time the Exercise Shares shall include any shares or other securities other than shares of Common Stock, or any other property or assets, the terms of this Warrant shall be modified or supplemented (and in the absence of express written documentation thereof, shall be deemed to be so modified or supplemented), and the Company shall take all actions as may be necessary to preserve, in a manner and on terms as nearly equivalent as practicable to the provisions of this Warrant as they apply to the Common Stock, the rights of the Holder hereunder, including any equitable replacements of the term "Common Stock" with the term "Exercise Shares" and adjustments of any formula included herein.

(c) The Company's filings under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), will comply in all material respects as to form with the Exchange Act and the rules and regulations thereunder.

(d) Without prior written consent of the Holder, the Company shall not permit any Significant Subsidiary (as defined by Rule 1-02(w) of Regulation S-X under the Securities Act or any successor rule) to (i) issue or grant any capital stock or equity ownership interest, including any Participating Security; (ii) any rights, options, warrants or convertible security that is exercisable for or convertible into any capital stock or other equity ownership interest, including any Participating Security; or (iii) any stock appreciation rights, phantom stock rights, or any other profit participation rights, or any rights or options to acquire any such rights, in each case of clauses (i), (ii) and (iii) above, to any Person other than the Company or its wholly owned subsidiaries.

(e) The Company shall not take any action that will result in an increase in the par value of the Common Stock.

3.2 No Impairment. Except and to the extent as waived or consented to in writing by the Holder, the Company will not, by amendment of its charter, bylaws or other governing documents or through any reorganization, transfer of assets, consolidation, merger, dissolution, issue or sale of securities or any other action, avoid or seek to avoid the observance or performance of any of the terms to be observed or performed hereunder by the Company, but will at all times in good faith assist in the carrying out of all the provisions of this Warrant and in the taking of all such action as may be necessary or appropriate in order to protect the exercise rights of the Holder against impairment or dilution consistent with the intent and principles

expressed herein. If any event or occurrence shall occur (including without limitation, stock dividends and stock splits) as to which the failure to make any adjustment to the Exercise Price and/or the number of shares or other assets or property subject to this Warrant would adversely affect the purchase rights or value represented by this Warrant, including any issuance of Common Stock or Participating Securities, then, in each such case, the Company shall determine the adjustment, if any, on a basis consistent with the essential intent and principles herein, necessary to preserve, without dilution, the purchase rights represented by this Warrant. If such determination involves or is based on a determination of the Fair Market Value of any securities or other assets or property, such determination shall be made in accordance with the Valuation Procedure. Without limiting the foregoing, in the event of any dividend or distribution by the Company of assets or property (including shares of any other Person) on or with respect to the Common Stock, or any exchange of the shares of Common Stock into any other assets, property or securities, this Warrant will be equitably adjusted to permit the Holder to receive upon exercise the assets, property or securities that would have been received if the Warrant had been exercised immediately prior to such dividend, distribution or exchange.

3.3 Notice of Record Date. In the event (i) the Company takes a record of the holders of any class of securities for the purpose of determining the holders thereof who are entitled to receive any dividend or other distribution, (ii) the Company authorizes the granting to the holders of Common Stock (or holders of the class of securities of any other Exercise Shares) of rights to subscribe to or purchase any shares of capital stock of any class or securities convertible into any shares of capital stock or of any other right, (iii) the Company authorizes any reclassification of, or any recapitalization involving, any class of Common Stock or any consolidation or merger to which the Company is a party and for which approval of the stockholders of the Company is required, or of the sale or transfer of all or substantially all of the assets of the Company, (iv) the Company authorizes or consents to or otherwise commences the voluntary or involuntary dissolution, liquidation or winding up of the Company or (v) the Company authorizes or takes any other action that would trigger an adjustment in the Exercise Price or the number or amount of shares of Common Stock or other Exercise Shares subject to this Warrant, the Company shall mail to the Holder, at least ten (10) days prior to the earlier of the record date for any such action or stockholder vote and the date of such action, a notice specifying (a) which action is to be taken and the date on which any such record is to be taken for the purpose of any such action, (b) the date that any such action is to take place and (c) the amount and character of any stock, other securities or property and amounts, or rights or options with respect thereto, proposed to be issued, granted or delivered to each holder of Common Stock (or holders of the class of securities of any other Exercise Shares).

4. Fractional Shares. No fractional shares shall be issued upon the exercise of this Warrant. All Exercise Shares (including fractions) issuable upon exercise of this Warrant may be aggregated for purposes of determining whether the exercise would result in the issuance of any fractional share. If, after aggregation, the exercise would result in the issuance of a fractional share, the Company shall, in lieu of issuance of any fractional share, pay the Holder otherwise entitled to such fraction a sum in cash equal to the product resulting from multiplying such fractional amount by the Fair Market Value of one share of Common Stock.

5. Listing Rights. The Company shall use its best efforts, upon the request of the Holder, to cause the Exercise Shares to be listed or quoted on a national securities exchange or a regional securities exchange.

6. No Stockholder Rights or Liabilities. Without limiting the consent rights of the Holder contained in Section 3, this Warrant in and of itself shall not entitle the Holder to any voting rights or other rights as a stockholder of the Company. No provision of this Warrant, in the absence of affirmative action by the Holder to exercise this Warrant in exchange for shares of Common Stock, and no mere enumeration herein of the rights or privileges of the Holder, shall give rise to any liability of the Holder for the Exercise Price or as a stockholder of the Company, whether such liability is asserted by the Company or by creditors of the Company.

7. Transfer of Warrant. This Warrant is not transferable; provided, however, that the Holder may assign its rights to receive shares upon exercise of this Warrant pursuant to Section 2.1.

8. Payment of Taxes on Stock Certificate Issues Upon Exercise. The initial issuance of certificates of Common Stock upon any exercise of this Warrant shall be made without charge to the exercising Holder for any transfer, stamp or similar tax or for any other governmental charges that may be imposed in respect of the issuance of such stock certificates, and such stock certificates shall be issued in the respective names of, or in such names as may be directed by, the Holder; provided, however, that the Company shall not be required to pay any tax or such other charges that may be payable in respect of any transfer involved in the issuance and delivery of any such stock certificate, any new warrants or other securities in a name other than that of the Holder upon exercise of this Warrant (other than to an Affiliate), and the Company shall not be required to issue or deliver such certificates or other securities unless and until the Person or Persons requesting the issuance thereof shall have paid to the Company the amount of such tax or shall have established to the satisfaction of the Company that such tax has been paid or is not payable.

9. Lost, Stolen, Mutilated or Destroyed Warrant. If this Warrant is lost, stolen, mutilated or destroyed, the Company may, on such terms as to indemnity or otherwise as it may reasonably impose (which shall, in the case of a mutilated Warrant, include the surrender thereof), issue a new Warrant of like denomination and tenor as this Warrant so lost, stolen, mutilated or destroyed. Any such new Warrant shall constitute an original contractual obligation of the Company, whether or not the allegedly lost, stolen, mutilated or destroyed Warrant shall be at any time enforceable by anyone.

10. Closing of Books. The Company will at no time close its transfer books against the transfer of any shares of Common Stock issued or issuable upon the exercise or conversion of any Warrant in any manner which interferes with the timely exercise or conversion of this Warrant.

11. Notices, Etc. All notices required or permitted hereunder shall be in writing and shall be deemed effectively given: (a) upon personal delivery to the party to be notified, (b) when sent by confirmed telex or facsimile if sent during normal business hours of the recipient or if not, then on the next Business Day, (c) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (d) one (1) Business Day after deposit with a nationally recognized overnight courier, specifying next Business Day delivery, with written verification of receipt. All notices and other communications shall be sent to the Company at the address listed on the signature page and to Holder at the address set forth below or at such other address as the Company or Holder may designate by ten (10) days advance written notice to the other parties hereto:

United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220
Attn: Under Secretary for Domestic Finance

with a copy to:

United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220
Attn: General Counsel

12. Acceptance. Receipt of this Warrant by the Holder shall constitute acceptance of and agreement to all of the terms and conditions contained herein.

13. Binding Effect on Successors. This Warrant shall be binding upon any Person succeeding the Company by merger, consolidation or acquisition of all or substantially all of the Company's assets, and all of the obligations of the Company relating to the Common Stock issuable upon the exercise or conversion of this Warrant shall survive the exercise, conversion and termination of this Warrant and all of the covenants and agreements of the Company shall inure to the benefit of the successors and assigns of the Holder.

14. Governing Law. This Warrant and all rights, obligations and liabilities hereunder shall be governed and construed in accordance with Federal law, if and to the extent such Federal law is applicable, and otherwise in accordance with the law of the State of New York.

IN WITNESS WHEREOF, the Company has caused this Warrant to be executed by its duly authorized officer as of September 7, 2008.

FEDERAL NATIONAL MORTGAGE ASSOCIATION,
by

The Federal Housing Finance Agency, its Conservator

____
James B. Lockhart III
Director

Address: 3900 Wisconsin Avenue, NW
Washington, DC 20016

NOTICE OF EXERCISE

TO: FEDERAL NATIONAL MORTGAGE ASSOCIATION

(1) ☐ The undersigned hereby elects to purchase _______________ shares of the Common Stock of Federal National Mortgage Association (the "Company") pursuant to the terms of the attached Warrant, and tenders herewith or is delivering by wire transfer to account number ____________ at _____________________ (bank) payment of the exercise price in full.

☐ The undersigned hereby elects to purchase ________ shares of the Common Stock of the Company pursuant to the terms of the net exercise provisions set forth in Section 2.2 of the attached Warrant.

(2) Please issue a certificate or certificates representing said shares of Common Stock in the name of the undersigned or in such other name as is specified below:

____
(Name)

____

____
(Address)

____
(Date)

____
(Signature)

____
(Print name)

SENIOR PREFERRED STOCK PURCHASE AGREEMENT

SENIOR PREFERRED STOCK PURCHASE AGREEMENT (this "Agreement") dated as of September 7, 2008, between the UNITED STATES DEPARTMENT OF THE TREASURY ("Purchaser") and FEDERAL HOME LOAN MORTGAGE CORPORATION ("Seller"), acting through the Federal Housing Finance Agency (the "Agency") as its duly appointed conservator (the Agency in such capacity, "Conservator"). Reference is made to Article 1 below for the meaning of capitalized terms used herein without definition.

Background

A. The Agency has been duly appointed as Conservator for Seller pursuant to Section 1367(a) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (as amended, the "FHE Act"). Conservator has determined that entry into this Agreement is (i) necessary to put Seller in a sound and solvent condition; (ii) appropriate to carry on the business of Seller and preserve and conserve the assets and property of Seller; and (iii) otherwise consistent with its powers, authorities and responsibilities.

B. Purchaser is authorized to purchase obligations and other securities issued by Seller pursuant to Section 306(l) of the Federal Home Loan Mortgage Corporation Act, as amended (the "Charter Act"). The Secretary of the Treasury has determined, after taking into consideration the matters set forth in Section 306(l)(1)(C) of the Charter Act, that the purchases contemplated herein are necessary to (i) provide stability to the financial markets; (ii) prevent disruptions in the availability of mortgage finance; and (iii) protect the taxpayer.

THEREFORE, the parties hereto agree as follows:

Terms and Conditions

1. DEFINITIONS

As used in this Agreement, the following terms shall have the meanings set forth below:

"*Affiliate*" means, when used with respect to a specified Person (i) any direct or indirect holder or group (as defined in Sections 13(d) and 14(d) of the Exchange Act) of holders of 10.0% or more of any class of capital stock of such Person and (ii) any current or former director or officer of such Person, or any other current or former employee of such Person that currently exercises or formerly exercised a material degree of Control over such Person, including without limitation each current or former Named Executive Officer of such Person.

"*Available Amount*" means, as of any date of determination, the lesser of (a) the Deficiency Amount as of such date and (b) the Maximum Amount as of such date.

"*Business Day*" means any day other than a Saturday, Sunday or other day on which commercial banks are authorized to close under United States federal law and the law of the State of New York.

"*Capital Lease Obligations*" of any Person shall mean the obligations of such Person to pay rent or other amounts under any lease of (or other similar arrangement conveying the right to use) real or personal property, or a combination thereof, which obligations are required to be classified and accounted for as capital leases on a balance sheet of such Person under GAAP and, for purposes hereof, the amount of such obligations at any time shall be the capitalized amount thereof at such time determined in accordance with GAAP.

"*Control*" shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a Person, whether through the ownership of voting securities, by contract or otherwise.

"*Deficiency Amount*" means, as of any date of determination, the amount, if any, by which (a) the total liabilities of Seller exceed (b) the total assets of Seller (such assets excluding the Commitment and any unfunded amounts thereof), in each case as reflected on the balance sheet of Seller as of the applicable date set forth in this Agreement, prepared in accordance with GAAP; provided, however, that:

(i) for the avoidance of doubt, in measuring the Deficiency Amount liabilities shall exclude any obligation in respect of any capital stock of Seller, including the Senior Preferred Stock contemplated herein;

(ii) in the event that Seller becomes subject to receivership or other liquidation process or proceeding, "Deficiency Amount" shall mean, as of any date of determination, the amount, if any, by which (a) the total allowed claims against the receivership or other applicable estate (excluding any liabilities of or transferred to any LLRE (as defined in Section 5.4(a)) created by a receiver) exceed (b) the total assets of such receivership or other estate (excluding the Commitment, any unfunded amounts thereof and any assets of or transferred to any LLRE, but including the value of the receiver's interest in any LLRE);

(iii) to the extent Conservator or a receiver of Seller, or any statute, rule, regulation or court of competent jurisdiction, specifies or determines that a liability of Seller (including without limitation a claim against Seller arising from rescission of a purchase or sale of a security issued by Seller (or guaranteed by Seller or with respect to which Seller is otherwise liable) or for damages arising from the purchase, sale or retention of such a security) shall be subordinated (other than pursuant to a contract providing for such subordination) to all other liabilities of Seller or shall be treated on par with any class of equity of Seller, then such liability shall be excluded in the calculation of Deficiency Amount; and

(iv) the Deficiency Amount may be increased above the otherwise applicable amount by the mutual written agreement of Purchaser and Seller, each acting in its sole discretion.

"*Designated Representative*" means Conservator or (a) if Conservator has been superseded by a receiver pursuant to Section 1367(a) of the FHE Act, such receiver, or (b) if Seller is not in con-

servatorship or receivership pursuant to Section 1367(a) of the FHE Act, Seller's chief financial officer.

"*Director*" shall mean the Director of the Agency.

"*Effective Date*" means the date on which this Agreement shall have been executed and delivered by both of the parties hereto.

"*Equity Interests*" of any Person shall mean any and all shares, interests, rights to purchase or otherwise acquire, warrants, options, participations or other equivalents of or interests in (however designated) equity, ownership or profits of such Person, including any preferred stock, any limited or general partnership interest and any limited liability company membership interest, and any securities or other rights or interests convertible into or exchangeable for any of the foregoing.

"*Exchange Act*" means the Securities Exchange Act of 1934, as amended, and the rules and regulations of the SEC promulgated thereunder.

"*GAAP*" means generally accepted accounting principles in effect in the United States as set forth in the opinions and pronouncements of the Accounting Principles Board and the American Institute of Certified Public Accountants and statements and pronouncements of the Financial Accounting Standards Board from time to time.

"*Indebtedness*" of any Person means, for purposes of Section 5.5 only, without duplication, (a) all obligations of such Person for money borrowed by such Person, (b) all obligations of such Person evidenced by bonds, debentures, notes or similar instruments, (c) all obligations of such Person under conditional sale or other title retention agreements relating to property or assets purchased by such Person, (d) all obligations of such Person issued or assumed as the deferred purchase price of property or services, other than trade accounts payable, (e) all Capital Lease Obligations of such Person, (f) obligations, whether contingent or liquidated, in respect of letters of credit (including standby and commercial), bankers' acceptances and similar instruments and (g) any obligation of such Person, contingent or otherwise, guaranteeing or having the economic effect of guaranteeing any Indebtedness of the types set forth in clauses (a) through (f) payable by another Person other than Mortgage Guarantee Obligations.

"*Liquidation End Date*" means the date of completion of the liquidation of Seller's assets.

"*Maximum Amount*" means, as of any date of determination, $100,000,000,000 (one hundred billion dollars), less the aggregate amount of funding under the Commitment prior to such date.

"*Mortgage Assets*" of any Person means assets of such Person consisting of mortgages, mortgage loans, mortgage-related securities, participation certificates, mortgage-backed commercial paper, obligations of real estate mortgage investment conduits and similar assets, in each case to the extent such assets would appear on the balance sheet of such Person in accordance with GAAP as in effect as of the date hereof (and, for the avoidance of doubt, without giving effect to any

change that may be made hereafter in respect of Statement of Financial Accounting Standards No. 140 or any similar accounting standard).

"*Mortgage Guarantee Obligations*" means guarantees, standby commitments, credit enhancements and other similar obligations of Seller, in each case in respect of Mortgage Assets.

"*Named Executive Officer*" has the meaning given to such term in Item 402(a)(3) of Regulation S-K under the Exchange Act, as in effect on the date hereof.

"*Person*" shall mean any individual, corporation, limited liability company, partnership, joint venture, association, joint-stock company, trust, estate, unincorporated organization or government or any agency or political subdivision thereof, or any other entity whatsoever.

"*SEC*" means the Securities and Exchange Commission.

"*Senior Preferred Stock*" means the Variable Liquidation Preference Senior Preferred Stock of Seller, substantially in the form of Exhibit A hereto.

"*Warrant*" means a warrant for the purchase of common stock of Seller representing 79.9% of the common stock of Seller on a fully-diluted basis, substantially in the form of Exhibit B hereto.

2. COMMITMENT

2.1. *Commitment.* Purchaser hereby commits to provide to Seller, on the terms and conditions set forth herein, immediately available funds in an amount up to but not in excess of the Available Amount, as determined from time to time (the "Commitment"); provided, that in no event shall the aggregate amount funded under the Commitment exceed $100,000,000,000 (one hundred billion dollars). The liquidation preference of the Senior Preferred Stock shall increase in connection with draws on the Commitment, as set forth in Section 3.3 below.

2.2. *Quarterly Draws on Commitment.* Within fifteen (15) Business Days following the determination of the Deficiency Amount, if any, as of the end of each fiscal quarter of Seller which ends on or before the Liquidation End Date, the Designated Representative may, on behalf of Seller, request that Purchaser provide immediately available funds to Seller in an amount up to but not in excess of the Available Amount as of the end of such quarter. Any such request shall be valid only if it is in writing, is timely made, specifies the account of Seller to which such funds are to be transferred, and contains a certification of the Designated Representative that the requested amount does not exceed the Available Amount as of the end of the applicable quarter. Purchaser shall provide such funds within sixty (60) days of its receipt of such request or, following any determination by the Director that the Director will be mandated by law to appoint a receiver for Seller if such funds are not received sooner, such shorter period as may be necessary to avoid such mandatory appointment of a receiver if reasonably practicable taking into consideration Purchaser's access to funds.

2.3. *Accelerated Draws on Commitment.* Immediately following any determination by the Director that the Director will be mandated by law to appoint a receiver for Seller prior to the Liquidation End Date unless Seller's capital is increased by an amount (the "Special Amount")

up to but not in excess of the then current Available Amount (computed based on a balance sheet of Seller prepared in accordance with GAAP that differs from the most recent balance sheet of Seller delivered in accordance with Section 5.9(a) or (b)) on a date that is prior to the date that funds will be available to Seller pursuant to Section 2.2, Conservator may, on behalf of Seller, request that Purchaser provide to Seller the Special Amount in immediately available funds. Any such request shall be valid only if it is in writing, is timely made, specifies the account of Seller to which such funds are to be transferred, and contains certifications of Conservator that (i) the requested amount does not exceed the Available Amount (including computations in reasonable detail and satisfactory to Purchaser of the then existing Deficiency Amount) and (ii) the requested amount is required to avoid the imminent mandatory appointment of a receiver for Seller. Purchaser shall provide such funds within thirty (30) days of its receipt of such request or, if reasonably practicable taking into consideration Purchaser's access to funds, any shorter period as may be necessary to avoid mandatory appointment of a receiver.

2.4. *Final Draw on Commitment.* Within fifteen (15) Business Days following the determination of the Deficiency Amount, if any, as of the Liquidation End Date (computed based on a balance sheet of Seller as of the Liquidation End Date prepared in accordance with GAAP), the Designated Representative may, on behalf of Seller, request that Purchaser provide immediately available funds to Seller in an amount up to but not in excess of the Available Amount as of the Liquidation End Date. Any such request shall be valid only if it is in writing, is timely made, specifies the account of Seller to which such funds are to be transferred, and contains a certification of the Designated Representative that the requested amount does not exceed the Available Amount (including computations in reasonable detail and satisfactory to Purchaser of the Deficiency Amount as of the Liquidation End Date). Purchaser shall provide such funds within sixty (60) days of its receipt of such request.

2.5. *Termination of Purchaser's Obligations.* Subject to earlier termination pursuant to Section 6.7, all of Purchaser's obligations under and in respect of the Commitment shall terminate upon the earliest of: (a) if the Liquidation End Date shall have occurred, (i) the payment in full of Purchaser's obligations with respect to any valid request for funds pursuant to Section 2.4 or (ii) if there is no Deficiency Amount on the Liquidation End Date or if no such request pursuant to Section 2.4 has been made, the close of business on the 15th Business Day following the determination of the Deficiency Amount, if any, as of the Liquidation End Date; (b) the payment in full of, defeasance of or other reasonable provision for all liabilities of Seller, whether or not contingent, including payment of any amounts that may become payable on, or expiry of or other provision for, all Mortgage Guarantee Obligations and provision for unmatured debts; and (c) the funding by Purchaser under the Commitment of an aggregate of $100,000,000,000 (one hundred billion dollars). For the avoidance of doubt, the Commitment shall *not* be terminable by Purchaser solely by reason of (i) the conservatorship, receivership or other insolvency proceeding of Seller or (ii) the Seller's financial condition or any adverse change in Seller's financial condition.

3. PURCHASE OF SENIOR PREFERRED STOCK AND WARRANT; FEES

3.1. *Initial Commitment Fee.* In consideration of the Commitment, and for no additional consideration, on the Effective Date (or as soon thereafter as is practicable) Seller shall sell and issue to Purchaser, and Purchaser shall purchase from Seller, (a) one million (1,000,000) shares of Senior Preferred Stock, with an initial liquidation preference equal to $1,000 per share

($1,000,000,000 (one billion dollars) liquidation preference in the aggregate), and (b) the Warrant.

3.2. *Periodic Commitment Fee.* (a) Commencing March 31, 2010, Seller shall pay to Purchaser quarterly, on the last day of March, June, September and December of each calendar year (each a "Periodic Fee Date"), a periodic commitment fee (the "Periodic Commitment Fee"). The Periodic Commitment Fee shall accrue from January 1, 2010.

(b) The Periodic Commitment Fee is intended to fully compensate Purchaser for the support provided by the ongoing Commitment following December 31, 2009. The amount of the Periodic Commitment Fee shall be set not later than December 31, 2009 with respect to the ensuing five-year period, shall be reset every five years thereafter and shall be determined with reference to the market value of the Commitment as then in effect. The amount of the Periodic Commitment Fee shall be mutually agreed by Purchaser and Seller, subject to their reasonable discretion and in consultation with the Chairman of the Federal Reserve; provided, that Purchaser may waive the Periodic Commitment Fee for up to one year at a time, in its sole discretion, based on adverse conditions in the United States mortgage market.

(c) At the election of Seller, the Periodic Commitment Fee may be paid in cash or by adding the amount thereof ratably to the liquidation preference of each outstanding share of Senior Preferred Stock so that the aggregate liquidation preference of all such outstanding shares of Senior Preferred Stock is increased by an amount equal to the Periodic Commitment Fee. Seller shall deliver notice of such election not later than three (3) Business Days prior to each Periodic Fee Date. If the Periodic Commitment Fee is not paid in cash by 12:00 pm (New York time) on the applicable Periodic Fee Date (irrespective of Seller's election pursuant to this subsection), Seller shall be deemed to have elected to pay the Periodic Commitment Fee by adding the amount thereof to the liquidation preference of the Senior Preferred Stock, and the aggregate liquidation preference of the outstanding shares of Senior Preferred Stock shall thereupon be automatically increased, in the manner contemplated by the first sentence of this section, by an aggregate amount equal to the Periodic Commitment Fee then due.

3.3. *Increases of Senior Preferred Stock Liquidation Preference as a Result of Funding under the Commitment.* The aggregate liquidation preference of the outstanding shares of Senior Preferred Stock shall be automatically increased by an amount equal to the amount of each draw on the Commitment pursuant to Article 2 that is funded by Purchaser to Seller, such increase to occur simultaneously with such funding and ratably with respect to each share of Senior Preferred Stock.

3.4. *Notation of Increase in Liquidation Preference.* Seller shall duly mark its records to reflect each increase in the liquidation preference of the Senior Preferred Stock contemplated herein (but, for the avoidance of doubt, such increase shall be effective regardless of whether Seller has properly marked its records).

4. REPRESENTATIONS

Seller represents and warrants as of the Effective Date, and shall be deemed to have represented and warranted as of the date of each request for and funding of an advance under the Commitment pursuant to Article 2, as follows:

4.1. *Organization and Good Standing.* Seller is a corporation, chartered by the Congress of the United States, duly organized, validly existing and in good standing under the laws of the United States and has all corporate power and authority to carry on its business as now conducted and as proposed to be conducted.

4.2. *Organizational Documents.* Seller has made available to Purchaser a complete and correct copy of its charter and bylaws, each as amended to date (the "Organizational Documents"). The Organizational Documents are in full force and effect. Seller is not in violation of any provision of its Organizational Documents.

4.3. *Authorization and Enforceability.* All corporate or other action on the part of Seller or Conservator necessary for the authorization, execution, delivery and performance of this Agreement by Seller and for the authorization, issuance and delivery of the Senior Preferred Stock and the Warrant being purchased under this Agreement, has been taken. This Agreement has been duly and validly executed and delivered by Seller and (assuming due authorization, execution and delivery by the Purchaser) shall constitute the valid and legally binding obligation of Seller, enforceable against Seller in accordance with its terms, except to the extent the enforceability thereof may be limited by bankruptcy laws, insolvency laws, reorganization laws, moratorium laws or other laws of general applicability affecting creditors' rights generally or by general equitable principles (regardless of whether enforcement is sought in a proceeding in equity or at law). The Agency is acting as conservator for Seller under Section 1367 of the FHE Act. The Board of Directors of Seller, by valid action at a duly called meeting of the Board of Directors on September 6, 2008, consented to the appointment of the Agency as conservator for purposes of Section 1367(a)(3)(I) of the FHE Act, and the Director of the Agency has appointed the Agency as Conservator for Seller pursuant to Section 1367(a)(1) of the FHE Act, and each such action has not been rescinded, revoked or modified in any respect.

4.4. *Valid Issuance.* When issued in accordance with the terms of this Agreement, the Senior Preferred Stock and the Warrant will be duly authorized, validly issued, fully paid and nonassessable, free and clear of all liens and preemptive rights. The shares of common stock to which the holder of the Warrant is entitled have been duly and validly reserved for issuance. When issued and delivered in accordance with the terms of this Agreement and the Warrant, such shares will be duly authorized, validly issued, fully paid and nonassessable, free and clear of all liens and preemptive rights.

4.5. *Non-Contravention.*

(a) The execution, delivery or performance by Seller of this Agreement and the consummation by Seller of the transactions contemplated hereby do not and will not (i) conflict with

or violate any provision of the Organizational Documents of Seller; (ii) conflict with or violate any law, decree or regulation applicable to Seller or by which any property or asset of Seller is bound or affected, or (iii) result in any breach of, or constitute a default (with or without notice or lapse of time, or both) under, or give to others any right of termination, amendment, acceleration or cancellation of, or result in the creation of a lien upon any of the properties or assets of Seller, pursuant to any note, bond, mortgage, indenture or credit agreement, or any other contract, agreement, lease, license, permit, franchise or other instrument or obligation to which Seller is a party or by which Seller is bound or affected, other than, in the case of clause (iii), any such breach, default, termination, amendment, acceleration, cancellation or lien that would not have and would not reasonably be expected to have, individually or in the aggregate, a material adverse effect on the business, property, operations or condition of the Seller, the authority of the Conservator or the validity or enforceability of this Agreement (a "Material Adverse Effect").

(b) The execution and delivery of this Agreement by Seller does not, and the consummation by Seller of the transactions contemplated by this Agreement will not, require any consent, approval, authorization, waiver or permit of, or filing with or notification to, any governmental authority or any other person, except for such as have already been obtained.

5. COVENANTS

From the Effective Date until such time as the Senior Preferred Stock shall have been repaid or redeemed in full in accordance with its terms:

5.1. *Restricted Payments*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, declare or pay any dividend (preferred or otherwise) or make any other distribution (by reduction of capital or otherwise), whether in cash, property, securities or a combination thereof, with respect to any of Seller's Equity Interests (other than with respect to the Senior Preferred Stock or the Warrant) or directly or indirectly redeem, purchase, retire or otherwise acquire for value any of Seller's Equity Interests (other than the Senior Preferred Stock or the Warrant), or set aside any amount for any such purpose.

5.2. *Issuance of Capital Stock*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, sell or issue Equity Interests of Seller or any of its subsidiaries of any kind or nature, in any amount, other than the sale and issuance of the Senior Preferred Stock and Warrant on the Effective Date and the common stock subject to the Warrant upon exercise thereof, and other than as required by (and pursuant to) the terms of any binding agreement as in effect on the date hereof.

5.3. *Conservatorship*. Seller shall not (and Conservator, by its signature below, agrees that it shall not), without the prior written consent of Purchaser, terminate, seek termination of or permit to be terminated the conservatorship of Seller pursuant to Section 1367 of the FHE Act, other than in connection with a receivership pursuant to Section 1367 of the FHE Act.

5.4. *Transfer of Assets*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, sell, transfer, lease or otherwise dispose

of (in one transaction or a series of related transactions) all or any portion of its assets (including Equity Interests in other persons, including subsidiaries), whether now owned or hereafter acquired (any such sale, transfer, lease or disposition, a "Disposition"), other than Dispositions for fair market value:

(a) to a limited life regulated entity ("LLRE") pursuant to Section 1367(i) of the FHE Act;

(b) of assets and properties in the ordinary course of business, consistent with past practice;

(c) in connection with a liquidation of Seller by a receiver appointed pursuant to Section 1367(a) of the FHE Act;

(d) of cash or cash equivalents for cash or cash equivalents; or

(e) to the extent necessary to comply with the covenant set forth in Section 5.7 below.

5.5. *Indebtedness.* Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, incur, assume or otherwise become liable for (a) any Indebtedness if, after giving effect to the incurrence thereof, the aggregate Indebtedness of Seller and its subsidiaries on a consolidated basis would exceed 110.0% of the aggregate Indebtedness of Seller and its subsidiaries on a consolidated basis as of June 30, 2008 or (b) any Indebtedness if such Indebtedness is subordinated by its terms to any other Indebtedness of Seller or the applicable subsidiary. For purposes of this covenant the acquisition of a subsidiary with Indebtedness will be deemed to be the incurrence of such Indebtedness at the time of such acquisition.

5.6. *Fundamental Changes.* Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, (i) merge into or consolidate or amalgamate with any other Person, or permit any other Person to merge into or consolidate or amalgamate with it, (ii) effect a reorganization or recapitalization involving the common stock of Seller, a reclassification of the common stock of Seller or similar corporate transaction or event or (iii) purchase, lease or otherwise acquire (in one transaction or a series of transactions) all or substantially all of the assets of any other Person or any division, unit or business of any Person.

5.7. *Mortgage Assets.* Seller shall not own, as of any applicable date, Mortgage Assets in excess of (i) on December 31, 2009, $850 billion, or (ii) on December 31 of each year thereafter, 90.0% of the aggregate amount of Mortgage Assets of Seller as of December 31 of the immediately preceding calendar year; provided, that in no event shall Seller be required under this Section 5.7 to own less than $250 billion in Mortgage Assets.

5.8. *Transactions with Affiliates.* Seller shall not, and shall not permit any of its subsidiaries to, without the prior written consent of Purchaser, engage in any transaction of any kind or nature with an Affiliate of Seller unless such transaction is (i) pursuant to this Agreement, the Senior Preferred Stock or the Warrant, (ii) upon terms no less favorable to Seller than would be ob-

tained in a comparable arm's-length transaction with a Person that is not an Affiliate of Seller or (iii) a transaction undertaken in the ordinary course or pursuant to a contractual obligation or customary employment arrangement in existence as of the date hereof.

5.9. *Reporting*. Seller shall provide to Purchaser:

(a) not later than the time period specified in the SEC's rules and regulations with respect to issuers as to which Section 13 and 15(d) of the Exchange Act apply, annual reports on Form 10-K (or any successor or comparable form) containing the information required to be contained therein (or required in such successor or comparable form);

(b) not later than the time period specified in the SEC's rules and regulations with respect to issuers as to which Section 13 and 15(d) of the Exchange Act apply, reports on Form 10-Q (or any successor or comparable form) containing the information required to be contained therein (or required in such successor or comparable form);

(c) promptly from time to time after the occurrence of an event required to be therein reported (and in any event within the time period specified in the SEC's rules and regulations), such other reports on Form 8-K (or any successor or comparable form);

(d) concurrently with any delivery of financial statements under paragraphs (a) or (b) above, a certificate of the Designated Representative, (i) certifying that Seller is (and since the last such certificate has at all times been) in compliance with each of the covenants contained herein and that no representation made by Seller herein or in any document delivered pursuant hereto or in connection herewith was false or misleading in any material respect when made, or, if the foregoing is not true, specifying the nature and extent of the breach of covenant and/or representation and any corrective action taken or proposed to be taken with respect thereto, and (ii) setting forth computations in reasonable detail and satisfactory to the Purchaser of the Deficiency Amount, if any;

(e) promptly, from time to time, such other information regarding the operations, business affairs, plans, projections and financial condition of Seller, or compliance with the terms of this Agreement, as Purchaser may reasonably request; and

(f) as promptly as reasonably practicable, written notice of the following:

(i) the occurrence of the Liquidation End Date;

(ii) the filing or commencement of, or any written threat or notice of intention of any Person to file or commence, any action, suit or proceeding, whether at law or in equity or by or before any governmental authority or in arbitration, against Conservator, Seller or any other Person which, if adversely determined, would reasonably be expected to have a Material Adverse Effect;

(iii) any other development that is not a matter of general public knowledge and that has had, or would reasonably be expected to have, a Material Adverse Effect.

5.10. *Executive Compensation*. Seller shall not, without the consent of the Director, in consultation with the Secretary of the Treasury, enter into any new compensation arrangements with, or increase amounts or benefits payable under existing compensation arrangements of, any Named Executive Officer of Seller.

6. MISCELLANEOUS

6.1. *No Third-Party Beneficiaries*. Until the termination of the Commitment, at any time during the existence and continuance of a payment default with respect to debt securities issued by Seller and/or a default by Seller with respect to any Mortgage Guarantee Obligations, any holder of such defaulted debt securities or beneficiary of such Mortgage Guarantee Obligations (collectively, the "Holders") may (a) deliver notice to the Seller and the Designated Representative requesting exercise of all rights available to them under this Agreement to draw on the Commitment up to the lesser of the amount necessary to cure the outstanding payment defaults and the Available Amount as of the last day of the immediately preceding fiscal quarter, and (b) if Seller and the Designated Representative fail to act as requested within thirty (30) days of such notice, or if Purchaser shall fail to perform its obligations in respect of any draw on the Commitment and Seller and/or the Designated Representative shall not be diligently pursuing remedies in respect of such failure, seek judicial relief requiring Seller to draw on the Commitment or Purchaser to fund the Commitment, as applicable. The Holders shall have no other rights under or in respect of this Agreement, and the Commitment shall not otherwise be enforceable by any creditor of Seller or by any other Person other than the parties hereto, and no such creditor or other Person is intended to be, or shall be, a third party beneficiary of any provision of this Agreement.

6.2. *Non-Transferable; Successors*. The Commitment is solely for the benefit of Seller and shall not inure to the benefit of any other Person (other than the Holders to the extent set forth in Section 6.1), including any entity to which the charter of Seller may be transferred, to any LLRE or to any other successor to the assets, liabilities or operations of Seller. The Commitment may not be assigned or otherwise transferred, in whole or in part, to any Person (including, for the avoidance of doubt, any LLRE to which a receiver has assigned all or a portion of Seller's assets) without the prior written consent of Purchaser (which may be withheld in its sole discretion). In no event shall any successor to Seller (including such an LLRE) be entitled to the benefit of the Commitment without the prior written consent of Purchaser. Seller and Conservator, for themselves and on behalf of their permitted successors, covenant and agree not to transfer or purport to transfer the Commitment in contravention of the terms hereof, and any such attempted transfer shall be null and void *ab initio*. It is the expectation of the parties that, in the event Seller were placed into receivership and an LLRE formed to purchase certain of its assets and assume certain of its liabilities, the Commitment would remain with Seller for the benefit of the holders of the debt of Seller not assumed by the LLRE.

6.3. *Amendments; Waivers*. This Agreement may be waived or amended solely by a writing executed by both of the parties hereto, and, with respect to amendments to or waivers of the provisions of Sections 5.3, 6.2 and 6.11, the Conservator; provided, however, that no such waiver or amendment shall decrease the aggregate Commitment or add conditions to funding the amounts required to be funded by Purchaser under the Commitment if such waiver or amendment would,

in the reasonable opinion of Seller, adversely affect in any material respect the holders of debt securities of Seller and/or the beneficiaries of Mortgage Guarantee Obligations, in each case in their capacities as such, after taking into account any alternative arrangements that may be implemented concurrently with such waiver or amendment. In no event shall any rights granted hereunder prevent the parties hereto from waiving or amending in any manner whatsoever the covenants of Seller hereunder.

6.4. *Governing Law; Jurisdiction; Venue.* This Agreement and the Warrant shall be governed by, and construed in accordance with, the federal law of the United States of America if and to the extent such federal law is applicable, and otherwise in accordance with the laws of the State of New York. The Senior Preferred Stock shall be governed as set forth in the terms thereof. The United States District Court for the District of Columbia shall have exclusive jurisdiction over all civil actions arising out of this Agreement, the Commitment, the Senior Preferred Stock and the Warrant, and venue for any such civil action shall lie exclusively in the United States District Court for the District of Columbia.

6.5. *Notices.* Any notices delivered pursuant to or in connection with this Agreement shall be delivered to the applicable parties at the addresses set forth below:

If to Seller:

Federal Home Loan Mortgage Corporation
c/o Federal Housing Finance Authority
1700 G Street, NW
4th Floor
Washington, DC 20552
Attention: General Counsel

If to Purchaser:

United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington DC 20220
Attention: Under Secretary for Domestic Finance

with a copy to:

United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington DC 20220
Attention: General Counsel

If to Conservator:

Federal Housing Finance Authority
1700 G Street, NW

4th Floor
Washington, DC 20552
Attention: General Counsel

All notices and other communications provided for herein shall be in writing and shall be delivered by hand or overnight courier service, mailed by certified or registered mail. All notices hereunder shall be effective upon receipt.

6.6. *Disclaimer of Guarantee.* This Agreement and the Commitment are not intended to and shall not be deemed to constitute a guarantee by Purchaser or any other agency or instrumentality of the United States of the payment or performance of any debt security or any other obligation, indebtedness or liability of Seller of any kind or character whatsoever.

6.7. *Effect of Order; Injunction; Decree.* If any order, injunction or decree is issued by any court of competent jurisdiction that vacates, modifies, amends, conditions, enjoins, stays or otherwise affects the appointment of Conservator as conservator of Seller or otherwise curtails Conservator's powers as such conservator (except in each case any order converting the conservatorship to a receivership under Section 1367(a) of the FHE Act), Purchaser may by written notice to Conservator and Seller declare this Agreement null and void, whereupon all transfers hereunder (including the issuance of the Senior Preferred Stock and the Warrant and any funding of the Commitment) shall be rescinded and unwound and all obligations of the parties (other than to effectuate such rescission and unwind) shall immediately and automatically terminate.

6.8. *Business Day.* To the extent that any deadline or date of performance of any right or obligation set forth herein shall fall on a day other than a Business Day, then such deadline or date of performance shall automatically be extended to the next succeeding Business Day.

6.9. *Entire Agreement.* This Agreement, together with the Senior Preferred Stock and Warrant, contains the entire agreement between the parties hereto with respect to the transactions contemplated hereby and supersedes and cancels all prior agreements, including, but not limited to, all proposals, term sheets, statements, letters of intent or representations, written or oral, with respect thereto.

6.10. *Remedies.* In the event of a breach by Seller of any covenant or representation of Seller set forth herein, Purchaser shall be entitled to specific performance (in the case of a breach of covenant), damages and such other remedies as may be available at law or in equity; provided, that Purchaser shall not have the right to terminate the Commitment solely as a result of any such breach, and compliance with the covenants and the accuracy of the representations set forth in this Agreement shall not be conditions to funding the Commitment.

6.11. *Tax Reporting.* Neither Seller nor Conservator shall take, or shall permit any of their respective successors or assigns to take, a position for any tax, accounting or other purpose that is inconsistent with Internal Revenue Service Notice 2008-76 (or the regulations to be issued pursuant to such Notice) regarding the application of Section 382 of the Internal Revenue Code of 1986, as amended, a copy of which Notice has been provided to Seller in connection with the execution of this Agreement.

6.12. *Non-Severability.* Each of the provisions of this Agreement is integrated with and integral to the whole and shall not be severable from the remainder of the Agreement. In the event that any provision of this Agreement, the Senior Preferred Stock or the Warrant is determined to be illegal or unenforceable, then Purchaser may, in its sole discretion, by written notice to Conservator and Seller, declare this Agreement null and void, whereupon all transfers hereunder (including the issuance of the Senior Preferred Stock and the Warrant and any funding of the Commitment) shall be rescinded and unwound and all obligations of the parties (other than to effectuate such rescission and unwind) shall immediately and automatically terminate.

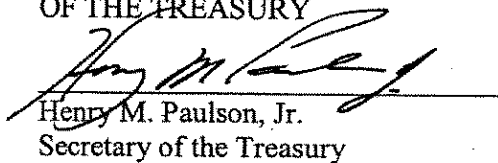
[Signature Page Follows]

FEDERAL HOME LOAN MORTGAGE CORPORATION, by

Federal Housing Finance Agency, its Conservator

James B. Lockhart III
Director

UNITED STATES DEPARTMENT OF THE TREASURY



Henry M. Paulson, Jr.
Secretary of the Treasury

Acknowledged and, solely as to Sections 5.3, 6.2 and 6.11, agreed:

FEDERAL HOUSING FINANCE AGENCY, as Conservator

James B. Lockhart III
Director

FREDDIE MAC

CERTIFICATE OF CREATION, DESIGNATION, POWERS, PREFERENCES, RIGHTS, PRIVILEGES, QUALIFICATIONS, LIMITATIONS, RESTRICTIONS, TERMS AND CONDITIONS OF VARIABLE LIQUIDATION PREFERENCE SENIOR PREFERRED STOCK (PAR VALUE $1.00 PER SHARE)

The Federal Housing Finance Agency, as Conservator of the Federal Home Loan Mortgage Corporation, a government-sponsored enterprise of the United States of America (the "Company"), does hereby certify that, pursuant to authority vested in the Board of Directors of the Company by Section 306(f) of the Federal Home Loan Mortgage Corporation Act, and pursuant to the authority vested in the Conservator of the Company by Section 1367(b) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. §4617), as amended, the Conservator adopted Resolution FHLMC 2008-___ on September 7, 2008, which resolution is now, and at all times since such date has been, in full force and effect, and that the Conservator approved the final terms of the issuance and sale of the preferred stock of the Company designated above.

The Senior Preferred Stock shall have the following designation, powers, preferences, rights, privileges, qualifications, limitations, restrictions, terms and conditions:

1. Designation, Par Value, Number of Shares and Seniority

The class of preferred stock of the Company created hereby (the "Senior Preferred Stock") shall be designated "Variable Liquidation Preference Senior Preferred Stock," shall have a par value of $1.00 per share and shall consist of 1,000,000 shares. The Senior Preferred Stock shall rank prior to the common stock of the Company as provided in this Certificate and shall rank, as to both dividends and distributions upon liquidation, prior to (a) the Fixed-to-Floating Rate Non-Cumulative Perpetual Preferred Stock issued on December 4, 2007, (b) the 6.55% Non-Cumulative Preferred Stock issued on September 28, 2007, (c) the 6.02% Non-Cumulative Preferred Stock issued on July 24, 2007, (d) the 5.66% Non-Cumulative Preferred Stock issued on April 16, 2007, (e) the 5.57% Non-Cumulative Preferred Stock issued on January 16, 2007, (f) the 5.9% Non-Cumulative Preferred Stock issued on October 16, 2006, (g) the 6.42% Non-Cumulative Preferred Stock issued on July 17, 2006, (h) the Variable Rate, Non-Cumulative Preferred Stock issued on July 17, 2006, (i) the 5.81% Non-Cumulative Preferred Stock issued on January 29, 2002, (j) the 5.7% Non-Cumulative Preferred Stock issued on October 30, 2001, (k) the 6% Non-Cumulative Preferred Stock issued on May 30, 2001, (l) the Variable Rate, Non-Cumulative Preferred Stock issued on May 30, 2001 and June 1, 2001, (m) the 5.81% Non-Cumulative Preferred Stock issued on March 23, 2001, (n) the Variable Rate, Non-Cumulative Preferred Stock issued on March 23, 2001, (o) the Variable Rate, Non-Cumulative Preferred Stock issued on January 26, 2001, (p) the Variable Rate, Non-Cumulative Preferred Stock issued on November 5, 1999, (q) the 5.79% Non-Cumulative Preferred Stock issued on July 21, 1999, (r) the 5.1% Non-Cumulative Preferred Stock issued on March 19, 1999, (s) the 5.3% Non-Cumulative Preferred Stock issued on October 28, 1998, (t) the

5.1% Non-Cumulative Preferred Stock issued on September 23, 1998, (u) the Variable Rate, Non-Cumulative Preferred Stock issued on September 23, 1998 and September 29, 1998, (v) the 5% Non-Cumulative Preferred Stock issued on March 23, 1998, (w) the 5.81% Non-Cumulative Preferred Stock issued on October 27, 1997, (x) the Variable Rate, Non-Cumulative Preferred Stock issued on April 26, 1996, (y) any other capital stock of the Company outstanding on the date of the initial issuance of the Senior Preferred Stock, and (z) any capital stock of the Company that may be issued after the date of initial issuance of the Senior Preferred Stock.

2. Dividends

(a) For each Dividend Period from the date of the initial issuance of the Senior Preferred Stock, holders of outstanding shares of Senior Preferred Stock shall be entitled to receive, ratably, when, as and if declared by the Board of Directors, in its sole discretion, out of funds legally available therefor, cumulative cash dividends at the annual rate per share equal to the then-current Dividend Rate on the then-current Liquidation Preference. Dividends on the Senior Preferred Stock shall accrue from but not including the date of the initial issuance of the Senior Preferred Stock and will be payable in arrears when, as and if declared by the Board of Directors quarterly on March 31, June 30, September 30 and December 31 of each year (each, a "Dividend Payment Date"), commencing on December 31, 2008. If a Dividend Payment Date is not a "Business Day," the related dividend will be paid not later than the next Business Day with the same force and effect as though paid on the Dividend Payment Date, without any increase to account for the period from such Dividend Payment Date through the date of actual payment. "Business Day" means a day other than (i) a Saturday or Sunday, (ii) a day on which New York City banks are closed, or (iii) a day on which the offices of the Company are closed.

If declared, the initial dividend will be for the period from but not including the date of the initial issuance of the Senior Preferred Stock through and including December 31, 2008. Except for the initial Dividend Payment Date, the "Dividend Period" relating to a Dividend Payment Date will be the period from but not including the preceding Dividend Payment Date through and including the related Dividend Payment Date. The amount of dividends payable on the initial Dividend Payment Date or for any Dividend Period that is not a full calendar quarter shall be computed on the basis of 30-day months, a 360-day year and the actual number of days elapsed in any period of less than one month. For the avoidance of doubt, in the event that the Liquidation Preference changes in the middle of a Dividend Period, the amount of dividends payable on the Dividend Payment Date at the end of such Dividend Period shall take into account such change in Liquidation Preference and shall be computed at the Dividend Rate on each Liquidation Preference based on the portion of the Dividend Period that each Liquidation Preference was in effect.

(b) To the extent not paid pursuant to Section 2(a) above, dividends on the Senior Preferred Stock shall accrue and shall be added to the Liquidation Preference pursuant to Section 8, whether or not there are funds legally available for the payment of such dividends and whether or not dividends are declared.

(c) "Dividend Rate" means 10.0%; provided, however, that if at any time the Company shall have for any reason failed to pay dividends in cash in a timely manner as required by this Certificate, then immediately following such failure and for all Dividend Periods thereafter until

the Dividend Period following the date on which the Company shall have paid in cash full cumulative dividends (including any unpaid dividends added to the Liquidation Preference pursuant to Section 8), the "Dividend Rate" shall mean 12.0%.

(d) Each such dividend shall be paid to the holders of record of outstanding shares of the Senior Preferred Stock as they appear in the books and records of the Company on such record date as shall be fixed in advance by the Board of Directors, not to be earlier than 45 days nor later than 10 days preceding the applicable Dividend Payment Date. The Company may not, at any time, declare or pay dividends on, make distributions with respect to, or redeem, purchase or acquire, or make a liquidation payment with respect to, any common stock or other securities ranking junior to the Senior Preferred Stock unless (i) full cumulative dividends on the outstanding Senior Preferred Stock in respect of the then-current Dividend Period and all past Dividend Periods (including any unpaid dividends added to the Liquidation Preference pursuant to Section 8) have been declared and paid in cash (including through any pay down of Liquidation Preference pursuant to Section 3) and (ii) all amounts required to be paid pursuant to Section 4 (without giving effect to any prohibition on such payment under any applicable law) have been paid in cash.

(e) Notwithstanding any other provision of this Certificate, the Board of Directors, in its discretion, may choose to pay dividends on the Senior Preferred Stock without the payment of any dividends on the common stock, preferred stock or any other class or series of stock from time to time outstanding ranking junior to the Senior Preferred Stock with respect to the payment of dividends.

(f) If and whenever dividends, having been declared, shall not have been paid in full, as aforesaid, on shares of the Senior Preferred Stock, all such dividends that have been declared on shares of the Senior Preferred Stock shall be paid to the holders pro rata based on the aggregate Liquidation Preference of the shares of Senior Preferred Stock held by each holder, and any amounts due but not paid in cash shall be added to the Liquidation Preference pursuant to Section 8.

3. Optional Pay Down of Liquidation Preference

(a) Following termination of the Commitment (as defined in the Preferred Stock Purchase Agreement referred to in Section 8 below), and subject to any limitations which may be imposed by law and the provisions below, the Company may pay down the Liquidation Preference of all outstanding shares of the Senior Preferred Stock pro rata, at any time, in whole or in part, out of funds legally available therefor, with such payment first being used to reduce any accrued and unpaid dividends previously added to the Liquidation Preference pursuant to Section 8 below and, to the extent all such accrued and unpaid dividends have been paid, next being used to reduce any Periodic Commitment Fees (as defined in the Preferred Stock Purchase Agreement referred to in Section 8 below) previously added to the Liquidation Preference pursuant to Section 8 below. Prior to termination of the Commitment, and subject to any limitations which may be imposed by law and the provisions below, the Company may pay down the Liquidation Preference of all outstanding shares of the Senior Preferred Stock pro rata, at any time, out of funds legally available therefor, but only to the extent of (i) accrued and unpaid dividends previously added to the Liquidation Preference pursuant to Section 8 below and not repaid by any prior pay down of Liquidation Preference and (ii) Periodic Commitment Fees previously added to the Liquidation

Preference pursuant to Section 8 below and not repaid by any prior pay down of Liquidation Preference. Any pay down of Liquidation Preference permitted by this Section 3 shall be paid by making a payment in cash to the holders of record of outstanding shares of the Senior Preferred Stock as they appear in the books and records of the Company on such record date as shall be fixed in advance by the Board of Directors, not to be earlier than 45 days nor later than 10 days preceding the date fixed for the payment.

(b) In the event the Company shall pay down of the Liquidation Preference of the Senior Preferred Stock as aforesaid, notice of such pay down shall be given by the Company by first class mail, postage prepaid, mailed neither less than 10 nor more than 45 days preceding the date fixed for the payment, to each holder of record of the shares of the Senior Preferred Stock, at such holder's address as the same appears in the books and records of the Company. Each such notice shall state the amount by which the Liquidation Preference of each share shall be reduced and the pay down date.

(c) If after termination of the Commitment the Company pays down the Liquidation Preference of each outstanding share of Senior Preferred Stock in full, such shares shall be deemed to have been redeemed as of the date of such payment, and the dividend that would otherwise be payable for the Dividend Period ending on the pay down date will be paid on such date. Following such deemed redemption, the shares of the Senior Preferred Stock shall no longer be deemed to be outstanding, and all rights of the holders thereof as holders of the Senior Preferred Stock shall cease, with respect to shares so redeemed, other than the right to receive the pay down amount (which shall include the final dividend for such shares). Any shares of the Senior Preferred Stock which shall have been so redeemed, after such redemption, shall no longer have the status of authorized, issued or outstanding shares.

4. Mandatory Pay Down of Liquidation Preference Upon Issuance of Capital Stock

(a) If the Company shall issue any shares of capital stock (including without limitation common stock or any series of preferred stock) in exchange for cash at any time while the Senior Preferred Stock is outstanding, then the Company shall, within 10 Business Days, use the proceeds of such issuance net of the direct costs relating to the issuance of such securities (including, without limitation, legal, accounting and investment banking fees) to pay down the Liquidation Preference of all outstanding shares of Senior Preferred Stock pro rata, out of funds legally available therefor, by making a payment in cash to the holders of record of outstanding shares of the Senior Preferred Stock as they appear in the books and records of the Company on such record date as shall be fixed in advance by the Board of Directors, not to be earlier than 45 days nor later than 10 days preceding the date fixed for the payment, with such payment first being used to reduce any accrued and unpaid dividends previously added to the Liquidation Preference pursuant to Section 8 below and, to the extent all such accrued and unpaid dividends have been paid, next being used to reduce any Periodic Commitment Fees (as defined in the Preferred Stock Purchase Agreement referred to in Section 8 below) previously added to the Liquidation Preference pursuant to Section 8 below; provided that, prior to the termination of the Commitment (as defined in the Preferred Stock Purchase Agreement referred to in Section 8 below), the Liquidation Preference of each share of Senior Preferred Stock shall not be paid down below $1,000 per share.

(b) If the Company shall not have sufficient assets legally available for the pay down of the Liquidation Preference of the shares of Senior Preferred Stock required under Section 4(a), the Company shall pay down the Liquidation Preference per share to the extent permitted by law, and shall pay down any Liquidation Preference not so paid down because of the unavailability of legally available assets or other prohibition as soon as practicable to the extent it is thereafter able to make such pay down legally. The inability of the Company to make such payment for any reason shall not relieve the Company from its obligation to effect any required pay down of the Liquidation Preference when, as and if permitted by law.

(c) If after the termination of the Commitment the Company pays down the Liquidation Preference of each outstanding share of Senior Preferred Stock in full, such shares shall be deemed to have been redeemed as of the date of such payment, and the dividend that would otherwise be payable for the Dividend Period ending on the pay down date will be paid on such date. Following such deemed redemption, the shares of the Senior Preferred Stock shall no longer be deemed to be outstanding, and all rights of the holders thereof as holders of the Senior Preferred Stock shall cease, with respect to shares so redeemed, other than the right to receive the pay down amount (which shall include the final dividend for such redeemed shares). Any shares of the Senior Preferred Stock which shall have been so redeemed, after such redemption, shall no longer have the status of authorized, issued or outstanding shares.

5. No Voting Rights

Except as set forth in this Certificate or otherwise required by law, the shares of the Senior Preferred Stock shall not have any voting powers, either general or special.

6. No Conversion or Exchange Rights

The holders of shares of the Senior Preferred Stock shall not have any right to convert such shares into or exchange such shares for any other class or series of stock or obligations of the Company.

7. No Preemptive Rights

No holder of the Senior Preferred Stock shall as such holder have any preemptive right to purchase or subscribe for any other shares, rights, options or other securities of any class of the Company which at any time may be sold or offered for sale by the Company.

8. Liquidation Rights and Preference

(a) Except as otherwise set forth herein, upon the voluntary or involuntary dissolution, liquidation or winding up of the Company, the holders of the outstanding shares of the Senior Preferred Stock shall be entitled to receive out of the assets of the Company available for distribution to stockholders, before any payment or distribution shall be made on the common stock or any other class or series of stock of the Company ranking junior to the Senior Preferred Stock upon liquidation, the amount per share equal to the Liquidation Preference plus an amount, determined in accordance with Section 2(a) above, equal to the dividend otherwise payable for the then-current Dividend Period accrued through and including the date of payment in respect of such dissolution, liquidation or winding up; provided, however, that if the assets of the Company

available for distribution to stockholders shall be insufficient for the payment of the amount which the holders of the outstanding shares of the Senior Preferred Stock shall be entitled to receive upon such dissolution, liquidation or winding up of the Company as aforesaid, then, all of the assets of the Company available for distribution to stockholders shall be distributed to the holders of outstanding shares of the Senior Preferred Stock pro rata based on the aggregate Liquidation Preference of the shares of Senior Preferred Stock held by each holder.

(b) "Liquidation Preference" shall initially mean $1,000 per share and shall be:

(i) increased each time a Deficiency Amount (as defined in the Preferred Stock Purchase Agreement) is paid to the Company by an amount per share equal to the aggregate amount so paid to the Company divided by the number of shares of Senior Preferred Stock outstanding at the time of such payment;

(ii) increased each time the Company does not pay the full Periodic Commitment Fee (as defined in the Preferred Stock Purchase Agreement) in cash by an amount per share equal to the amount of the Periodic Commitment Fee that is not paid in cash divided by the number of shares of Senior Preferred Stock outstanding at the time such payment is due;

(iii) increased on the Dividend Payment Date if the Company fails to pay in full the dividend payable for the Dividend Period ending on such date by an amount per share equal to the aggregate amount of unpaid dividends divided by the number of shares of Senior Preferred Stock outstanding on such date; and

(iv) decreased each time the Company pays down the Liquidation Preference pursuant to Section 3 or Section 4 of this Certificate by an amount per share equal to the aggregate amount of the pay down divided by the number of shares of Senior Preferred Stock outstanding at the time of such pay down.

(c) "Preferred Stock Purchase Agreement" means the Preferred Stock Purchase Agreement, dated September 7, 2008, between the Company and the United States Department of the Treasury.

(d) Neither the sale of all or substantially all of the property or business of the Company, nor the merger, consolidation or combination of the Company into or with any other corporation or entity, shall be deemed to be a dissolution, liquidation or winding up for the purpose of this Section 8.

9. Additional Classes or Series of Stock

The Board of Directors shall have the right at any time in the future to authorize, create and issue, by resolution or resolutions, one or more additional classes or series of stock of the Company, and to determine and fix the distinguishing characteristics and the relative rights, preferences, privileges and other terms of the shares thereof; provided that, any such class or series of stock may not rank prior to or on parity with the Senior Preferred Stock without the prior written consent of the holders of at least two-thirds of all the shares of Senior Preferred Stock at the time outstanding.

10. Miscellaneous

(a) The Company and any agent of the Company may deem and treat the holder of a share or shares of Senior Preferred Stock, as shown in the Company's books and records, as the absolute owner of such share or shares of Senior Preferred Stock for the purpose of receiving payment of dividends in respect of such share or shares of Senior Preferred Stock and for all other purposes whatsoever, and neither the Company nor any agent of the Company shall be affected by any notice to the contrary. All payments made to or upon the order of any such person shall be valid and, to the extent of the sum or sums so paid, effectual to satisfy and discharge liabilities for moneys payable by the Company on or with respect to any such share or shares of Senior Preferred Stock.

(b) The shares of the Senior Preferred Stock, when duly issued, shall be fully paid and non-assessable.

(c) The Senior Preferred Stock may be issued, and shall be transferable on the books of the Company, only in whole shares.

(d) For purposes of this Certificate, the term "the Company" means the Federal Home Loan Mortgage Corporation and any successor thereto by operation of law or by reason of a merger, consolidation, combination or similar transaction.

(e) This Certificate and the respective rights and obligations of the Company and the holders of the Senior Preferred Stock with respect to such Senior Preferred Stock shall be construed in accordance with and governed by the laws of the United States, provided that the law of the Commonwealth of Virginia shall serve as the federal rule of decision in all instances except where such law is inconsistent with the Company's enabling legislation, its public purposes or any provision of this Certificate.

(f) Any notice, demand or other communication which by any provision of this Certificate is required or permitted to be given or served to or upon the Company shall be given or served in writing addressed (unless and until another address shall be published by the Company) to Freddie Mac, 8200 Jones Branch Drive, McLean, Virginia 22102, Attn: Executive Vice President and General Counsel. Such notice, demand or other communication to or upon the Company shall be deemed to have been sufficiently given or made only upon actual receipt of a writing by the Company. Any notice, demand or other communication which by any provision of this Certificate is required or permitted to be given or served by the Company hereunder may be given or served by being deposited first class, postage prepaid, in the United States mail addressed (i) to the holder as such holder's name and address may appear at such time in the books and records of the Company or (ii) if to a person or entity other than a holder of record of the Senior Preferred Stock, to such person or entity at such address as reasonably appears to the Company to be appropriate at such time. Such notice, demand or other communication shall be deemed to have been sufficiently given or made, for all purposes, upon mailing.

(g) The Company, by or under the authority of the Board of Directors, may amend, alter, supplement or repeal any provision of this Certificate pursuant to the following terms and conditions:

(i) Without the consent of the holders of the Senior Preferred Stock, the Company may amend, alter, supplement or repeal any provision of this Certificate to cure any ambiguity, to correct or supplement any provision herein which may be defective or inconsistent with any other provision herein, or to make any other provisions with respect to matters or questions arising under this Certificate, provided that such action shall not adversely affect the interests of the holders of the Senior Preferred Stock.

(ii) The consent of the holders of at least two-thirds of all of the shares of the Senior Preferred Stock at the time outstanding, given in person or by proxy, either in writing or by a vote at a meeting called for the purpose at which the holders of shares of the Senior Preferred Stock shall vote together as a class, shall be necessary for authorizing, effecting or validating the amendment, alteration, supplementation or repeal (whether by merger, consolidation or otherwise) of the provisions of this Certificate other than as set forth in subparagraph (i) of this paragraph (g). The creation and issuance of any other class or series of stock, or the issuance of additional shares of any existing class or series of stock, of the Company ranking junior to the Senior Preferred Stock shall not be deemed to constitute such an amendment, alteration, supplementation or repeal.

(iii) Holders of the Senior Preferred Stock shall be entitled to one vote per share on matters on which their consent is required pursuant to subparagraph (ii) of this paragraph (g). In connection with any meeting of such holders, the Board of Directors shall fix a record date, neither earlier than 60 days nor later than 10 days prior to the date of such meeting, and holders of record of shares of the Senior Preferred Stock on such record date shall be entitled to notice of and to vote at any such meeting and any adjournment. The Board of Directors, or such person or persons as it may designate, may establish reasonable rules and procedures as to the solicitation of the consent of holders of the Senior Preferred Stock at any such meeting or otherwise, which rules and procedures shall conform to the requirements of any national securities exchange on which the Senior Preferred Stock may be listed at such time.

(h) **RECEIPT AND ACCEPTANCE OF A SHARE OR SHARES OF THE SENIOR PREFERRED STOCK BY OR ON BEHALF OF A HOLDER SHALL CONSTITUTE THE UNCONDITIONAL ACCEPTANCE BY THE HOLDER (AND ALL OTHERS HAVING BENEFICIAL OWNERSHIP OF SUCH SHARE OR SHARES) OF ALL OF THE TERMS AND PROVISIONS OF THIS CERTIFICATE. NO SIGNATURE OR OTHER FURTHER MANIFESTATION OF ASSENT TO THE TERMS AND PROVISIONS OF THIS CERTIFICATE SHALL BE NECESSARY FOR ITS OPERATION OR EFFECT AS BETWEEN THE COMPANY AND THE HOLDER (AND ALL SUCH OTHERS).**

IN WITNESS WHEREOF, I have hereunto set my hand and the seal of the Company this 7th day of September, 2008.

[Seal]

FEDERAL HOME LOAN MORTGAGE CORPORATION,
by

The Federal Housing Finance Agency, its Conservator

____

James B. Lockhart III
Director

FEDERAL HOME LOAN MORTGAGE CORPORATION
WARRANT TO PURCHASE COMMON STOCK

NO. _____ September 7, 2008

VOID AFTER SEPTEMBER 7, 2028

THIS CERTIFIES THAT, for value received, the United States Department of the Treasury, with its principal office at 1500 Pennsylvania Avenue, NW, Washington, DC 20220 (the "Holder"), is entitled to purchase at the Exercise Price (defined below) from Federal Home Loan Mortgage Corporation, a government-sponsored enterprise of the United States of America, with its principal office at 8200 Jones Branch Drive, McLean, Virginia 22102 (the "Company"), shares of common stock, no par value, of the Company, as provided herein.

1. Definitions. As used herein, the following terms shall have the following respective meanings:

"Affiliate" shall mean, as to any specified Person, any other Person directly or indirectly controlling or controlled by or under direct or indirect common control with such specified Person. For the purposes of this definition, "control," when used with respect to any Person, means the power to direct the management and policies of such Person, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise and the terms "affiliated," "controlling" and "controlled" have meanings correlative to the foregoing.

"Business Day" shall mean each Monday, Tuesday, Wednesday, Thursday and Friday that is not a day on which banking institutions in New York, New York are authorized or obligated by law or executive order to close.

"Common Stock" shall mean the common stock, no par value, of the Company, and all other stock of any class or classes (however designated) of the Company from time to time outstanding, the holders of which have the right, without limitation as to amount, either to all or to a share of the balance of current dividends or liquidating distributions after the payment of dividends and distributions on any shares entitled to preference.

"Exercise Period" shall mean the time period commencing with the date hereof and ending at 5:00 p.m. New York time on the 20th anniversary of the date hereof.

"Exercise Price" shall mean one one-thousandth of a cent ($0.00001) per share.

"Exercise Shares" shall mean the shares of the Common Stock issuable upon exercise of this Warrant, subject to adjustment pursuant to the terms herein, and shall also mean any other shares, securities, assets or property otherwise issuable upon exercise of this Warrant.

"Fair Market Value" shall mean, with respect to a share of Common Stock, or any other security of the Company or any other issuer:

(a) the volume weighted average daily Market Price during the period of the most recent twenty (20) Trading Days, ending on the last Trading Day before the date of determination of Fair Market Value, if such class of Common Stock or other security is (i) traded

on the New York Stock Exchange or any other U.S. national or regional securities exchange, or admitted to unlisted trading privileges on such an exchange, or (ii) is quoted or reported on the Over-the-Counter Bulletin Board ("OTCBB") or by Pink OTC Markets Inc. or a similar organization or agency succeeding to its functions of reporting prices; or

(b) if such class of Common Stock or other security is not then so listed, admitted to trading or quoted, the Fair Market Value shall be the Market Price on the last Business Day before the date of determination of Fair Market Value.

"Fully Diluted" shall mean, as of immediately prior to the exercise of this Warrant (or a portion of this Warrant), the sum of, without duplication, (i) the total number of shares of Common Stock outstanding and (ii) all shares of Common Stock issuable in respect of securities convertible into or exercisable or exchangeable for Common Stock, stock appreciation rights or options, warrants (including this Warrant) and other rights to purchase or subscribe for Common Stock or securities convertible into or exercisable or exchangeable for Common Stock (in each case, assuming that no restrictions apply with respect to conversion, exercise, exchange, subscription or purchase).

"Market Price" shall be, as of any specified date with respect to any share of any class of Common Stock or any other security of the Company or any other issuer:

(i) the closing price on that date or, if no closing price is reported, the last reported sale price, of shares of the Common Stock or such other security on the New York Stock Exchange on that date; or

(ii) if the Common Stock or such other security is not traded on the New York Stock Exchange, the closing price on that date as reported in composite transactions for the principal U.S. national or regional securities exchange on which the Common Stock or such other security is so traded or, if no closing price is reported, the last reported sale price of shares of the Common Stock or such other security on the principal U.S. national or regional securities exchange on which the Common Stock or such other security is so traded on that date; or

(iii) if the Common Stock or such other security is not traded on a U.S. national or regional securities exchange, the last quoted bid price on that date for the Common Stock or such other security in the over-the-counter market as reported (x) by the OTCBB or (y) if reports are unavailable under clause (x) above by Pink OTC Markets Inc. or a similar organization or agency succeeding to its functions of reporting prices;

(iv) if the Common Stock or such other security is not so quoted by OTCBB or Pink OTC Markets Inc. or a similar organization, the Market Price shall be determined in accordance with the Valuation Procedure.

"Participating Securities" shall mean, (i) any equity security (other than Common Stock) that entitles the holders thereof to participate in liquidations or other distributions with the holders of Common Stock or otherwise participate in the capital of the Company other than through a fixed or floating rate of return on capital loaned or invested, and (ii) any stock appreciation rights, phantom stock rights, or any other profit participation rights with respect to

any of the Company's capital stock or other equity ownership interest, or any rights or options to acquire any such rights.

"Person" shall mean any individual, corporation, limited liability company, partnership, joint venture, association, joint-stock company, trust, estate, unincorporated organization or government or any agency or political subdivision thereof, or any other entity whatsoever.

"Trading Day" shall mean, with respect to any class of Common Stock or any other security of the Company or any other issuer a day (i) on which the securities exchange or other trading platform applicable for purposes of determining the Market Price of a share or unit of such class of Common Stock or other security shall be open for business or (ii) for which quotations from such securities exchange or other trading platform of the character specified for purposes of determining such Market Price shall be reported.

"Valuation Procedure" shall mean a determination made in good faith by the Board of Directors of the Company (the "Board") that is set forth in resolutions of the Board that are certified by the Secretary of the Company, which certified resolutions (i) set forth the basis of the Board's determination, which, in the case of a valuation in excess of $100 million, shall include the Board's reliance on the valuation of a nationally recognized investment banking or appraisal firm, and (ii) are delivered to the Holder within ten (10) Business Days following such determination. A Valuation Procedure with respect to the value of any capital stock shall be based on the price that would be paid for all of the capital stock of the issuer in an arm's-length transaction between a willing buyer and a willing seller (neither acting under compulsion).

2. Exercise of Warrant; Number of Shares.

2.1 Exercise. This Warrant may be exercised in whole or in part at any time during the Exercise Period, by delivery of the following to the Company at its address set forth above (or at such other address as it may designate by notice in writing to the Holder):

(a) an executed Notice of Exercise in the form attached hereto;

(b) payment of the Exercise Price (i) in cash or by check, (ii) by cancellation of indebtedness or (iii) pursuant to Section 2.2 hereof; and

(c) this Warrant.

This Warrant will be exercisable for a number of shares of Common Stock that, together with the shares of Common Stock previously issued pursuant to this Warrant, is equal to 79.9% of the total number of shares of Common Stock outstanding on a Fully Diluted basis on the date of exercise. Whenever the Holder exercises this Warrant in whole or in part, it may assign its right to receive the Exercise Shares issuable upon such exercise to any other Person.

As soon as practicable (and in any event within five Business Days) after this Warrant shall have been exercised, a certificate or certificates for the Exercise Shares so purchased, registered in the name of the Holder or such other Person as may be designated by the Holder (to the extent such transfer is not validly restricted and upon payment of any transfer taxes that are

required to be paid by the Holder in connection with any such transfer), shall be issued and delivered by the Company to the Holder or such other Person .

The Person in whose name any certificate or certificates for the Exercise Shares are to be issued upon exercise of this Warrant shall be deemed to have become the holder of record of such shares on the date on which this Warrant was surrendered and payment of the Exercise Price was made, irrespective of the date of delivery of such certificate or certificates, except that, if the date of such surrender and payment is a date when the stock transfer books of the Company are closed, such Person shall be deemed to have become the holder of such shares at the close of business on the next succeeding date on which the stock transfer books are open (whether before or after the end of the Exercise Period).

2.2 Net Exercise. Notwithstanding any provision herein to the contrary, if the Market Price of one share of the Common Stock is greater than the Exercise Price (at the date of calculation as set forth below), in lieu of exercising this Warrant by payment of cash, check or cancellation of indebtedness, the Holder may elect (the "Conversion Right") to receive shares equal to the value (as determined below) of this Warrant (or the portion thereof being canceled) by surrender of this Warrant at the principal office of the Company together with the properly endorsed Notice of Exercise in which event the Company shall issue to the Holder a number of shares of Common Stock computed using the following formula:

$$X = \frac{Y\,(A-B)}{A}$$

Where X = the number of shares of Common Stock to be issued

Y = the number of shares of Common Stock purchasable under this Warrant or, if only a portion of this Warrant is being exercised, the portion of this Warrant being exercised (at the date of such calculation)

A = the Market Price of one share of the Common Stock (at the date of such calculation)

B = Exercise Price (as adjusted pursuant to the terms herein to the date of such calculation)

The Company shall pay all reasonable administrative costs incurred by the Holder in connection with the exercise of the Conversion Right by the Holder pursuant to this Section 2.2.

3. Covenants and Representations of the Company

3.1 Covenants as to Exercise Shares.

(a) The Company covenants and agrees that all Exercise Shares that may be issued upon the exercise of this Warrant will, upon issuance, be validly authorized, issued and outstanding, fully paid and nonassessable, free of preemptive rights and free from all taxes, liens and charges with respect to the issuance thereof. If the Common Stock or the class of securities of any other Exercise Shares is then listed or quoted on a national securities exchange

or a regional securities exchange, all such Exercise Shares shall, upon issuance, also be so listed or quoted. The Company further covenants and agrees that the Company will at all times during the Exercise Period, have authorized and reserved solely for purposes of the exercise of this Warrant, free from preemptive rights, a sufficient number of shares of its Common Stock or the class of securities of any other Exercise Shares to provide for the exercise in full of this Warrant (without taking into account any possible exercise pursuant to Section 2.2 hereof). If at any time during the Exercise Period the number of authorized but unissued shares of Common Stock or the class of securities of any other Exercise Shares shall not be sufficient to permit exercise in full of this Warrant (without taking into account any possible exercise pursuant to Section 2.2 hereof), the Company will take such corporate action as shall be necessary to increase its authorized but unissued shares of Common Stock or the class of securities of any other Exercise Shares to such number of shares as shall be sufficient for such purposes.

(b) If at any time the Exercise Shares shall include any shares or other securities other than shares of Common Stock, or any other property or assets, the terms of this Warrant shall be modified or supplemented (and in the absence of express written documentation thereof, shall be deemed to be so modified or supplemented), and the Company shall take all actions as may be necessary to preserve, in a manner and on terms as nearly equivalent as practicable to the provisions of this Warrant as they apply to the Common Stock, the rights of the Holder hereunder, including any equitable replacements of the term "Common Stock" with the term "Exercise Shares" and adjustments of any formula included herein.

(c) The Company's filings under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), will comply in all material respects as to form with the Exchange Act and the rules and regulations thereunder.

(d) Without prior written consent of the Holder, the Company shall not permit any Significant Subsidiary (as defined by Rule 1-02(w) of Regulation S-X under the Securities Act or any successor rule) to (i) issue or grant any capital stock or equity ownership interest, including any Participating Security; (ii) any rights, options, warrants or convertible security that is exercisable for or convertible into any capital stock or other equity ownership interest, including any Participating Security; or (iii) any stock appreciation rights, phantom stock rights, or any other profit participation rights, or any rights or options to acquire any such rights, in each case of clauses (i), (ii) and (iii) above, to any Person other than the Company or its wholly owned subsidiaries.

(e) The Company shall not take any action that will result in an increase in the par value of the Common Stock.

3.2 No Impairment. Except and to the extent as waived or consented to in writing by the Holder, the Company will not, by amendment of its charter, bylaws or other governing documents or through any reorganization, transfer of assets, consolidation, merger, dissolution, issue or sale of securities or any other action, avoid or seek to avoid the observance or performance of any of the terms to be observed or performed hereunder by the Company, but will at all times in good faith assist in the carrying out of all the provisions of this Warrant and in the taking of all such action as may be necessary or appropriate in order to protect the exercise rights of the Holder against impairment or dilution consistent with the intent and principles

expressed herein. If any event or occurrence shall occur (including without limitation, stock dividends and stock splits) as to which the failure to make any adjustment to the Exercise Price and/or the number of shares or other assets or property subject to this Warrant would adversely affect the purchase rights or value represented by this Warrant, including any issuance of Common Stock or Participating Securities, then, in each such case, the Company shall determine the adjustment, if any, on a basis consistent with the essential intent and principles herein, necessary to preserve, without dilution, the purchase rights represented by this Warrant. If such determination involves or is based on a determination of the Fair Market Value of any securities or other assets or property, such determination shall be made in accordance with the Valuation Procedure. Without limiting the foregoing, in the event of any dividend or distribution by the Company of assets or property (including shares of any other Person) on or with respect to the Common Stock, or any exchange of the shares of Common Stock into any other assets, property or securities, this Warrant will be equitably adjusted to permit the Holder to receive upon exercise the assets, property or securities that would have been received if the Warrant had been exercised immediately prior to such dividend, distribution or exchange.

3.3 Notice of Record Date. In the event (i) the Company takes a record of the holders of any class of securities for the purpose of determining the holders thereof who are entitled to receive any dividend or other distribution, (ii) the Company authorizes the granting to the holders of Common Stock (or holders of the class of securities of any other Exercise Shares) of rights to subscribe to or purchase any shares of capital stock of any class or securities convertible into any shares of capital stock or of any other right, (iii) the Company authorizes any reclassification of, or any recapitalization involving, any class of Common Stock or any consolidation or merger to which the Company is a party and for which approval of the stockholders of the Company is required, or of the sale or transfer of all or substantially all of the assets of the Company, (iv) the Company authorizes or consents to or otherwise commences the voluntary or involuntary dissolution, liquidation or winding up of the Company or (v) the Company authorizes or takes any other action that would trigger an adjustment in the Exercise Price or the number or amount of shares of Common Stock or other Exercise Shares subject to this Warrant, the Company shall mail to the Holder, at least ten (10) days prior to the earlier of the record date for any such action or stockholder vote and the date of such action, a notice specifying (a) which action is to be taken and the date on which any such record is to be taken for the purpose of any such action, (b) the date that any such action is to take place and (c) the amount and character of any stock, other securities or property and amounts, or rights or options with respect thereto, proposed to be issued, granted or delivered to each holder of Common Stock (or holders of the class of securities of any other Exercise Shares).

4. Fractional Shares. No fractional shares shall be issued upon the exercise of this Warrant. All Exercise Shares (including fractions) issuable upon exercise of this Warrant may be aggregated for purposes of determining whether the exercise would result in the issuance of any fractional share. If, after aggregation, the exercise would result in the issuance of a fractional share, the Company shall, in lieu of issuance of any fractional share, pay the Holder otherwise entitled to such fraction a sum in cash equal to the product resulting from multiplying such fractional amount by the Fair Market Value of one share of Common Stock.

5. Listing Rights. The Company shall use its best efforts, upon the request of the Holder, to cause the Exercise Shares to be listed or quoted on a national securities exchange or a regional securities exchange.

6. No Stockholder Rights or Liabilities. Without limiting the consent rights of the Holder contained in Section 3, this Warrant in and of itself shall not entitle the Holder to any voting rights or other rights as a stockholder of the Company. No provision of this Warrant, in the absence of affirmative action by the Holder to exercise this Warrant in exchange for shares of Common Stock, and no mere enumeration herein of the rights or privileges of the Holder, shall give rise to any liability of the Holder for the Exercise Price or as a stockholder of the Company, whether such liability is asserted by the Company or by creditors of the Company.

7. Transfer of Warrant. This Warrant is not transferable; provided, however, that the Holder may assign its rights to receive shares upon exercise of this Warrant pursuant to Section 2.1.

8. Payment of Taxes on Stock Certificate Issues Upon Exercise. The initial issuance of certificates of Common Stock upon any exercise of this Warrant shall be made without charge to the exercising Holder for any transfer, stamp or similar tax or for any other governmental charges that may be imposed in respect of the issuance of such stock certificates, and such stock certificates shall be issued in the respective names of, or in such names as may be directed by, the Holder; provided, however, that the Company shall not be required to pay any tax or such other charges that may be payable in respect of any transfer involved in the issuance and delivery of any such stock certificate, any new warrants or other securities in a name other than that of the Holder upon exercise of this Warrant (other than to an Affiliate), and the Company shall not be required to issue or deliver such certificates or other securities unless and until the Person or Persons requesting the issuance thereof shall have paid to the Company the amount of such tax or shall have established to the satisfaction of the Company that such tax has been paid or is not payable.

9. Lost, Stolen, Mutilated or Destroyed Warrant. If this Warrant is lost, stolen, mutilated or destroyed, the Company may, on such terms as to indemnity or otherwise as it may reasonably impose (which shall, in the case of a mutilated Warrant, include the surrender thereof), issue a new Warrant of like denomination and tenor as this Warrant so lost, stolen, mutilated or destroyed. Any such new Warrant shall constitute an original contractual obligation of the Company, whether or not the allegedly lost, stolen, mutilated or destroyed Warrant shall be at any time enforceable by anyone.

10. Closing of Books. The Company will at no time close its transfer books against the transfer of any shares of Common Stock issued or issuable upon the exercise or conversion of any Warrant in any manner which interferes with the timely exercise or conversion of this Warrant.

11. Notices, Etc. All notices required or permitted hereunder shall be in writing and shall be deemed effectively given: (a) upon personal delivery to the party to be notified, (b) when sent by confirmed telex or facsimile if sent during normal business hours of the recipient or if not, then on the next Business Day, (c) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (d) one (1) Business Day after deposit with a nationally recognized overnight courier, specifying next Business Day delivery, with written verification of receipt. All notices and other communications shall be sent to the Company at the address listed on the signature page and to Holder at the address set forth below or at such other address as the Company or Holder may designate by ten (10) days advance written notice to the other parties hereto:

United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220
Attn: Under Secretary for Domestic Finance

with a copy to:

United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220
Attn: General Counsel

12. Acceptance. Receipt of this Warrant by the Holder shall constitute acceptance of and agreement to all of the terms and conditions contained herein.

13. Binding Effect on Successors. This Warrant shall be binding upon any Person succeeding the Company by merger, consolidation or acquisition of all or substantially all of the Company's assets, and all of the obligations of the Company relating to the Common Stock issuable upon the exercise or conversion of this Warrant shall survive the exercise, conversion and termination of this Warrant and all of the covenants and agreements of the Company shall inure to the benefit of the successors and assigns of the Holder.

14. Governing Law. This Warrant and all rights, obligations and liabilities hereunder shall be governed and construed in accordance with Federal law, if and to the extent such Federal law is applicable, and otherwise in accordance with the law of the State of New York.

IN WITNESS WHEREOF, the Company has caused this Warrant to be executed by its duly authorized officer as of September 7, 2008.

FEDERAL HOME LOAN MORTGAGE CORPORATION, by

The Federal Housing Finance Agency, its Conservator

____

James B. Lockhart III
Director

Address: 8200 Jones Branch Drive
McLean, Virginia 22102

NOTICE OF EXERCISE

TO: FEDERAL HOME LOAN MORTGAGE CORPORATION

(1) ☐ The undersigned hereby elects to purchase _______________ shares of the Common Stock of Federal Home Loan Mortgage Corporation (the "Company") pursuant to the terms of the attached Warrant, and tenders herewith or is delivering by wire transfer to account number ____________ at _____________________ (bank) payment of the exercise price in full.

☐ The undersigned hereby elects to purchase ________ shares of the Common Stock of the Company pursuant to the terms of the net exercise provisions set forth in Section 2.2 of the attached Warrant.

(2) Please issue a certificate or certificates representing said shares of Common Stock in the name of the undersigned or in such other name as is specified below:

____
(Name)

____

____
(Address)

____
(Date)

____
(Signature)

____
(Print name)

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UNITED STATES SECURITIES AND EXCHANGE COMMISSIONWashington, D.C. 20549
FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended September 30, 2008 or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the transition period from to Commission File Number: 000-53330
Federal Home Loan Mortgage Corporation(Exact name of registrant as specified in its charter) Freddie Mac

Federally chartered corporation	52-0904874
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
8200 Jones Branch Drive, McLean, Virginia	22102-3110
(Address of principal executive offices)	(Zip Code)

(703) 903-2000 (Registrant's telephone number, including area code) Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. x Yes o No Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company o
x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes x No As of November 10, 2008, there were 647,158,633 shares of the registrant's common stock outstanding.

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PART I -- FINANCIAL INFORMATION This Quarterly Report on Form 10-Q includes forward-looking statements, which may include expectations and objectives related to our operating results, financial condition, business, capital management, remediation of significant deficiencies in internal controls, credit losses, market share and trends, the conservatorship and its effects on our business and other matters. You should not rely unduly on our forward-looking statements. Actual results might differ significantly from those described in or implied by such forward-looking statements due to various factors and uncertainties, including those described in (i) "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS," or MD&A, "FORWARD-LOOKING STATEMENTS" and "RISK FACTORS" in this Form 10-Q and in the comparably captioned sections of our Form 10-Q for the quarter ended June 30, 2008 and our Form 10 Registration Statement filed and declared effective by the SEC on July 18, 2008, or Registration Statement, and (ii) the "BUSINESS" section of our Registration Statement. These forward-looking statements are made as of the date of this Form 10-Q and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date of this Form 10-Q, or to reflect the occurrence of unanticipated events. ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS EXECUTIVE SUMMARY Conservatorship Entry Into Conservatorship and Treasury Agreements On September 7, 2008, Henry M. Paulson, Jr., Secretary of the U.S. Department of the Treasury, or Treasury, and James B. Lockhart III, Director of the Federal Housing Finance Agency, or FHFA, announced several actions taken by Treasury and FHFA regarding Freddie Mac and Fannie Mae. Director Lockhart stated that they took these actions "to help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, and mitigate the systemic risk that has contributed directly to the instability in the current market." These actions included the following:

ù placing us and Fannie Mae in conservatorship;
ù the execution of a senior preferred stock purchase agreement by our Conservator, on our behalf, and Treasury, pursuant to which we issued to Treasury both senior preferred stock and a warrant to purchase common stock; and
ù the agreement to establish a temporary secured lending credit facility that is available to us.

Entry into Conservatorship On September 6, 2008, at the request of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve and the Director of FHFA, our Board of Directors adopted a resolution consenting to putting the company into conservatorship. After obtaining this consent, the Director of FHFA appointed FHFA as our Conservator on September 6, 2008, in accordance with the Federal Housing Finance Regulatory Reform Act of 2008, or Reform Act, and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. Upon its appointment, the Conservator immediately succeeded to all rights, titles, powers and privileges of Freddie Mac, and of any stockholder, officer or director of Freddie Mac with respect to Freddie Mac and its assets, and succeeded to the title to all books, records and assets of Freddie Mac held by any other legal custodian or third party. The Conservator has the power to take over our assets and operate our business with all the powers of our stockholders, directors and officers, and

to conduct all business of the company. The Conservator announced at that time that it would eliminate the payment of dividends on common and preferred stock during the conservatorship. On September 7, 2008, the Director of FHFA issued a statement that he had determined that we could not continue to operate safely and soundly and fulfill our critical public mission without significant action to address FHFA's concerns, which were principally: safety and soundness concerns as they existed at that time, including our capitalization; market conditions; our financial performance and condition; our inability to obtain funding according to normal practices and prices; and our critical importance in supporting the U.S. residential mortgage market. We describe the terms of the conservatorship and the powers of our Conservator in detail below under "Legislative and Regulatory Matters -- Conservatorship and Treasury Agreements." Overview of Treasury Agreements Senior Preferred Stock Purchase Agreement The Conservator, acting on our behalf, entered into a senior preferred stock purchase agreement, or Purchase Agreement, with Treasury on September 7, 2008. Under the Purchase Agreement, Treasury provided us with its commitment to provide up to $100 billion in funding under specified conditions. The Purchase Agreement requires Treasury, upon the request of the Conservator, to provide funds to us after any quarter in which we have a negative net worth (that is, our total liabilities exceed our total assets, as reflected on our GAAP balance sheet). In addition, the Purchase Agreement requires

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Treasury, upon the request of the Conservator, to provide funds to us if the Conservator determines, at any time, that it will be mandated by law to appoint a receiver for us unless we receive funds from Treasury under the Commitment. In exchange for Treasury's funding commitment, we issued to Treasury, as an initial commitment fee: (1) one million shares of Variable Liquidation Preference Senior Preferred Stock (with an initial liquidation preference of $1 billion), which we refer to as the senior preferred stock; and (2) a warrant to purchase, for a nominal price, shares of our common stock equal to 79.9% of the total number of shares of our common stock outstanding on a fully diluted basis at the time the warrant is exercised, which we refer to as the warrant. We received no other consideration from Treasury as a result of issuing the senior preferred stock or the warrant. Under the terms of the agreement, Treasury is entitled to a quarterly dividend of 10% per year (which increases to 12% per year if not paid timely and in cash) on the aggregate liquidation preference of the senior preferred stock. To the extent we are required to draw on Treasury's funding commitment the liquidation preference of the senior preferred stock will be increased by the amount of any funds we receive. The amounts payable for this dividend could be substantial and have an adverse impact on our financial position and net worth. The senior preferred stock is senior in liquidation preference to our common stock and all other series of preferred stock. In addition, beginning on March 31, 2010, we are required to pay a quarterly commitment fee to Treasury, which will accrue from January 1, 2010. We are required to pay this fee each quarter for as long as the Purchase Agreement is in effect. The amount of this fee has not yet been determined. The Purchase Agreement includes significant restrictions on our ability to manage our business, including limiting the amount of indebtedness we can incur to 110% of our aggregate indebtedness as of June 30, 2008 and capping the size of our retained portfolio at $850 billion as of December 31, 2009. See "CONSOLIDATED BALANCE SHEETS ANALYSIS -- Retained Portfolio" and "OUR PORTFOLIOS" for a description and composition of our portfolios. In addition, beginning in 2010, we must decrease the size of our retained portfolio at the rate of 10% per year until it reaches $250 billion. Depending on the pace of future mortgage liquidations, we may need to reduce or eliminate our purchases of mortgage assets or sell mortgage assets to achieve this reduction. We currently do not have plans to sell our mortgage assets at a loss. In addition,

while the senior preferred stock is outstanding, we are prohibited from paying dividends (other than on the senior preferred stock) or issuing equity securities without Treasury's consent. The terms of the Purchase Agreement and warrant make it unlikely that we will be able to obtain equity from private sources. The Purchase Agreement has an indefinite term and can terminate only in very limited circumstances, which do not include the end of the conservatorship. The agreement therefore could continue after the conservatorship ends. Treasury has the right to exercise the warrant, in whole or in part, at any time on or before September 7, 2028. We provide more detail about the provisions of the Purchase Agreement, the senior preferred stock and the warrant, the limited circumstances under which those agreements terminate, and the limitations they place on our ability to manage our business under "Legislative and Regulatory Matters -- Conservatorship and Treasury Agreements" below. See "ITEM 1A. RISK FACTORS" for a discussion of how the restrictions under the Purchase Agreement may have a material adverse effect on our business. Expected Draw Under the Purchase Agreement At September 30, 2008, our liabilities exceeded our assets under GAAP by $(13.7) billion while our stockholders' equity (deficit) totaled $(13.8) billion. The Director of FHFA has submitted a request under the Purchase Agreement in the amount of $13.8 billion to Treasury. We expect to receive such funds by November 29, 2008. If the Director of FHFA were to determine in writing that our assets are, and have been for a period of 60 days, less than our obligations to creditors and others, FHFA would be required to place us into receivership. As a result of this draw, the aggregate liquidation preference of the senior preferred stock will increase to $14.8 billion, and our annual aggregate dividend payment to Treasury, at the 10% dividend rate, would increase to $1.5 billion. If we are unable to pay such dividend in cash in any quarter, the unpaid amount will be added to the aggregate liquidation preference of the senior preferred stock and the dividend rate on the unpaid liquidation preference will increase to 12% per year. Treasury Credit Facility On September 18, 2008, we entered into a lending agreement with Treasury, or Lending Agreement, pursuant to which Treasury established a new secured lending credit facility that is available to us until December 31, 2009 as a liquidity back-stop. In order to borrow pursuant to the Lending Agreement, we are required to post collateral in the form of Freddie Mac or Fannie Mae mortgage-backed securities to secure all borrowings under the facility. The terms of any borrowings under the Lending Agreement, including the interest rate payable on the loan and the amount of collateral we will need to provide as security for the loan, will be determined by Treasury. Treasury is not obligated under the Lending Agreement to make any loan to us. Treasury does not have authority to extend the term of this credit facility beyond December 31, 2009, which is when Treasury's temporary authority to purchase our obligations and other securities, granted by the Reform Act, expires. After December 31, 2009, Treasury may purchase up to $2.25 billion of our obligations under its permanent authority, as set forth in our charter.

As of November 14, 2008, we have not borrowed any amounts under the Lending Agreement. The terms of the Lending Agreement are described in more detail in "Legislative and Regulatory Matters -- Conservatorship and Treasury Agreements." Changes in Company Management and our Board of Directors Since our entry into conservatorship on September 6, 2008, eight members of our Board of Directors have resigned, including Richard F. Syron, our former Chairman and Chief Executive Officer. On September 16, 2008, the Conservator appointed John A. Koskinen as the new non-executive Chairman of our Board of Directors. We currently have four members of our Board of Directors and nine vacancies. As noted above, as our Conservator, FHFA has assumed the powers of our Board of Directors. Accordingly, the current Board of Directors acts with neither the power nor the duty to manage, direct or oversee our business and affairs. The

Conservator has indicated that it intends to appoint a full Board of Directors to which it will delegate specified roles and responsibilities. On September 7, 2008, the Conservator appointed David M. Moffett as our Chief Executive Officer, effective immediately. Since September 7, 2008, we have announced the departures of our former Chief Financial Officer and our former Chief Business Officer. Supervision of our Business under the Reform Act and During Conservatorship During the third quarter of 2008, the company experienced a number of significant changes in our regulatory supervisory environment. First, on July 30, 2008, President Bush signed into law the Reform Act, which placed us under the regulation of a new regulator, FHFA. That legislation strengthened the existing safety and soundness oversight of the government sponsored enterprises, or GSEs, and provided FHFA with new safety and soundness authority that is comparable to, and in some respects, broader than that of the federal bank agencies. That legislation gave FHFA enhanced powers that, even if we were not placed into conservatorship, gave them the authority to raise capital levels above statutory minimum levels, regulate the size and content of our portfolio, and to approve new mortgage products. That legislation also gave FHFA the authority to place the GSEs into conservatorship or receivership under conditions set forth in the statute. Refer to "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS -- EXECUTIVE SUMMARY -- Legislative and Regulatory Matters" in our Form 10-Q for the period ended June 30, 2008 for additional detail regarding the provisions of the Reform Act. See "ITEM 1A. RISK FACTORS," for additional risks and information regarding this legislation, including the receivership provisions. Second, we experienced a change in control when we were placed into conservatorship on September 6, 2008. Under conservatorship, we have additional heightened supervision and direction from our regulator, FHFA, who is also acting as our Conservator. Below is a summary comparison of various features of our business before and after we were placed into conservatorship and entered into the Purchase Agreement. Following this summary, we provide additional information about a number of aspects of our business now that we are in conservatorship under "Managing Our Business During Conservatorship -- Our Objectives." In addition, we describe the impacts of the Treasury agreements on our business above under "Overview of Treasury Agreements" and below under "Legislative and Regulatory Matters -- Conservatorship and Treasury Agreements."

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Topic	Before Conservatorship	During Conservatorship
Authority of Board of Directors, Management and Stockholders	ù Board of Directors with right to determine the general policies governing the operations of the corporation and exercise all power and authority of the company except as vested in stockholders or as the Board chooses to delegate to management	ù FHFA, as Conservator, has all of the power and authority of the Board of Directors, management and the shareholders
	ù Board of Directors delegated significant authority to management	ù The Conservator has delegated authority to management to conduct day-to-day operations so that the company can continue to operate in the

		ordinary course of business. The Conservator retains overall management authority, including the authority to withdraw its delegations to us at any time.
	ù Stockholders with specified voting rights	ù Stockholders have no voting rights
Regulatory Supervision	ù Regulated by FHFA, our new regulator created by the Reform Act	ù Regulated by FHFA, with powers as provided by Reform Act
	ù Reform Act gave regulator significant additional safety and soundness supervisory powers	ù Additional management authority by FHFA, which is serving as our Conservator
Structure of Board of Directors	ù 13 directors: 11 independent, plus Chairman and Chief Executive Officer, and one vacancy; independent, non-management lead director	ù Currently, four directors, consisting of a non-management Chairman of the Board and three independent directors (who were also directors of Freddie Mac immediately prior to conservatorship), with neither the power nor the duty to manage, direct or oversee our business and affairs
	ù Five separate Board committees, including Audit Committee in which one of the five independent members was an "audit committee financial expert"	ù No Board committees have members or authority to act
		ù Conservator has indicated its intent to appoint a full Board of Directors to which it will delegate specified roles and responsibilities
Management	ù Richard F. Syron served as Chairman and Chief Executive Officer from December 2003 to September 6, 2008	ù David M. Moffett began serving as Chief Executive Officer on September 7, 2008
Capital	ù Statutory and regulatory capital requirements	ù Capital requirements not binding
	ù Capital classifications as to adequacy of capital provided by FHFA on quarterly basis	ù Quarterly capital classifications by FHFA suspended
Net Worth(1)	ù Receivership mandatory if we have negative net worth for 60 days	ù Conservator has directed management to focus on maintaining positive stockholders' equity in order to avoid both the need to request

		funds under the Purchase Agreement and our mandatory receivership
		ù Receivership mandatory if we have negative net worth for 60 days(2)
Managing for the Benefit of Shareholders	ù Maximize shareholder value over the long term	ù No longer managed with a strategy to maximize common shareholder returns
	ù Fulfill our mission of providing liquidity, stability and affordability to the mortgage market	ù Maintain positive net worth and fulfill our mission of providing liquidity, stability and affordability to the mortgage market
		ù Focus on returning to long-term profitability if it does not adversely affect our ability to maintain net worth or fulfill our mission

(1) Our net worth refers to our assets less our liabilities, as reflected on our GAAP balance sheet. If we have a negative net worth (which means that our liabilities exceed our assets, as reflected on our GAAP balance sheet), then, if requested by the Conservator (or by our Chief Financial Officer, if we are not under conservatorship), Treasury is required to provide funds to us pursuant to the Purchase Agreement. Net worth is substantially the same as stockholders' equity (deficit); however, net worth also includes the minority interests that third parties own in our consolidated subsidiaries (which was $95 million as of September 30, 2008). At September 30, 2008, we had a negative net worth of $13.7 billion. In addition, if the Director of FHFA were to determine in writing that our assets are, and would have been for a period of 60 days, less than our obligations to creditors and others, FHFA would be required to place us into receivership.
(2) Treasury's funding commitment under the Purchase Agreement is expected to enable us to maintain a positive net worth as long as Treasury has not invested the full $100 billion provided for in that agreement.

The conservatorship has no specified termination date. There can be no assurance as to when or how the conservatorship will be terminated, whether we will continue to exist following conservatorship, or what our business structure will be during or following our conservatorship. In a statement issued on September 7, 2008, the Secretary of the Treasury indicated that 2008 and 2009 should be viewed as a "time out" where we and Fannie Mae are stabilized while policymakers decide our future role and structure. He also stated that there is a consensus that we and Fannie Mae pose a systemic risk and that we cannot continue in our current form. For more information on the

risks to our business relating to the conservatorship and uncertainties regarding the future of our business, see "ITEM 1A. RISK FACTORS." Managing Our Business During Conservatorship Our Management FHFA, in its role as Conservator, has overall management authority over our business. During the conservatorship, the Conservator has delegated authority to management to conduct day-to-day operations so that the company can continue to operate in the ordinary course of business. We can, and have continued to, enter into and enforce contracts with third parties. The Conservator retains the authority to withdraw its delegations to us at any time. The Conservator is working actively with management to address and determine the strategic direction for the enterprise, and in general has retained final decision-making authority in areas regarding: significant impacts on operational, market, reputational or credit risk; major accounting determinations, including policy changes; the creation of subsidiaries or affiliates and transacting with them; significant litigation; setting executive compensation; retention of external auditors; significant mergers and acquisitions; and any other matters the Conservator believes are strategic or critical to the enterprise in order for the Conservator to fulfill its obligations during conservatorship. See "Conservatorship and Treasury Agreements -- Conservatorship -- General Powers of the Conservator Under the Regulatory Reform Act" for more information. Our Objectives Based on the Federal Home Loan Mortgage Corporation Act, which we refer to as our charter, public statements from Treasury officials and guidance from our Conservator, we have a variety of different, and potentially conflicting, objectives, including:

ù providing liquidity, stability and affordability in the mortgage market;
ù immediately providing additional assistance to the struggling housing and mortgage markets;
ù reducing the need to draw funds from Treasury pursuant to the Purchase Agreement;
ù returning to long-term profitability; and
ù protecting the interests of the taxpayers.

These objectives create conflicts in strategic and day-to-day decision making that will likely lead to less than optimal outcomes for one or more, or possibly all, of these objectives. For example, maintaining a positive net worth could require us to constrain some of our business activities, including activities that provide liquidity, stability and affordability to the mortgage market. Conversely, to the extent we increase activities to assist the mortgage market, our financial results are likely to suffer, and we may be less able to maintain a positive net worth. We regularly consult with and get direction from our Conservator on how to balance these objectives. To the extent that we are unable to maintain a positive net worth following our expected draw of funds from Treasury after the filing of this Form 10-Q, we will be required to request additional funding from Treasury under the Purchase Agreement, which will further increase our ongoing dividend obligations and, therefore, extend the period of time until we might be able to return to profitability. These objectives also create risks that we discuss in "ITEM 1A. RISK FACTORS." Changes in Strategies to Meet New Objectives Since September 6, 2008, we have made a number of changes in the strategies we use to manage our business in support of our new objectives outlined above. These include the changes we describe below. Eliminating Planned Increase in Adverse Market Delivery Charge As part of our efforts to increase liquidity in the mortgage market and make mortgage loans more affordable, we announced on October 3, 2008 that we were eliminating our previously announced 25 basis point increase in our adverse market delivery charge that was scheduled to take effect on November 7, 2008. The elimination of this charge will reduce our future net income. Temporarily Increasing the Size of Our Mortgage Portfolio Consistent with our ability under the senior preferred stock purchase agreement to increase the size of our on-balance sheet mortgage portfolio through the end of 2009, FHFA has directed us to acquire and hold increased amounts of mortgage loans and mortgage-related securities in our mortgage portfolio to provide additional liquidity to the mortgage market. Our extremely limited ability to issue callable or long-term debt at this time makes it difficult to increase the size of our mortgage portfolio. In addition, we are also subject to the covenant in the senior

preferred stock purchase agreement

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prohibiting us from issuing debt in excess of 110% of our aggregate indebtedness as of June 30, 2008. For a discussion of the limitations we are currently experiencing on our ability to issue debt securities, see "LIQUIDITY AND CAPITAL RESOURCES" and "RISK FACTORS." Current Conditions in the Housing and Mortgage Market Deterioration in Market Conditions and Impact on Third Quarter Results Market conditions affecting the company deteriorated dramatically during the third quarter. This had a materially adverse impact on our quarterly results of operations in the third quarter of 2008 compared to the second quarter of 2008. Home prices nationwide resumed the rate of decline experienced earlier in the year after briefly leveling off during the second quarter of 2008. The percentage decline in home prices was particularly large in California, Florida, Arizona and Nevada, where Freddie Mac has significant concentrations of mortgage loans. Unemployment rates also worsened significantly. California, Arizona and Nevada saw increases of between 14 and 27% in unemployment from the second quarter to the third quarter of 2008, on a seasonally-adjusted basis, while the national rate exceeded 6%. Unemployment rates increased again in October to a national rate of 6.5%. An upward spike in food and other goods prices during the third quarter of 2008 further eroded household financial conditions, and real consumer spending declined significantly. Both consumer and business credit tightened considerably during the third quarter of 2008 as financial institutions curtailed their lending activities. This contributed to significant increases in credit spreads for both mortgage and corporate loans. These macro-economic conditions and other factors contributed to a substantial increase in the number of delinquent loans in our single-family mortgage portfolio during the third quarter of 2008. The rate of transition of these loans from delinquency through foreclosure also increased. We observed a significant increase in market-reported delinquency rates for mortgages serviced by financial institutions not only for subprime and Alt-A loans but also for prime loans. This delinquency data suggests that continuing home price declines and growing unemployment are now affecting behavior by a broader segment of mortgage borrowers, increasing numbers of whom are "underwater," or owing more on their mortgage loans than their homes are currently worth. Our loan loss severities, or the average amount of recognized losses per loan, also increased in the third quarter of 2008, especially in California, Florida and Arizona, where home price declines have been more severe and where we have significant concentrations of mortgage loans with higher average loan balances than in other states. We were not the only financial institution that was adversely affected by the worsening market conditions during the third quarter of 2008. IndyMac Bank, FSB and Washington Mutual Bank were placed into receivership, and Lehman Brothers Holdings, Inc., or Lehman, filed for bankruptcy. American International Group, Inc. received a substantial infusion of cash from the U.S. government, and both Merrill Lynch & Co, Inc. and Wachovia Corporation were acquired by other institutions. In an attempt to stabilize the markets and restore liquidity, the U.S. government introduced several unprecedented programs to provide various forms of financial support to market participants. One of these proposed programs involves guarantees by the Federal Deposit Insurance Corporation, or FDIC, of the debt obligations issued by banks. This proposal and other existing programs have created uncertainty in the market resulting in limited access to long-term and callable funding. Uncertainty has also contributed to increased borrowing costs relative to the U.S. Treasury market and the London Interbank Offered Rate, or LIBOR. See "LIQUIDITY AND CAPITAL RESOURCES" for further information. These market developments have been the principal drivers of our substantially increased loss for the third quarter of 2008. Our provision for credit losses increased from $2.5 billion in the second quarter of 2008 to $5.7 billion in

the third quarter of 2008, principally due to increased estimates of incurred losses caused by the deteriorating economic conditions and evidenced by our increased rates of delinquency and foreclosure; increased mortgage loan loss severities; and, to a much lesser extent, heightened concerns that certain of our seller/servicer counterparties may fail to perform their recourse or repurchase obligations to us. Our security impairments on available for sale securities increased from $1.0 billion in the second quarter of 2008 to $9.1 billion in the third quarter of 2008. The deteriorating market conditions during the third quarter also led to a considerably more pessimistic outlook for the performance of the non-agency mortgage-related securities in our retained portfolio. The loans backing these securities exhibited much worse delinquency behavior than that mentioned above with respect to loans in our guarantee portfolio. Rising unemployment, accelerating house price declines, tight credit conditions, volatility in interest rates, and weakening consumer confidence not only contributed to poor performance during the third quarter but significantly impacted our expectations regarding future performance, both of which are critical in assessing security impairments. Furthermore, the mortgage-related securities backed by subprime and Alt-A and other loans, including Moving Treasury Average, or MTA, loans, have significantly greater concentrations in the states that are undergoing the greatest stress, including California, Florida, Arizona and Nevada. MTA adjustable-rate mortgages (also referred to as option ARMs) have adjustable interest rates and optional payment terms, including options that result in negative amortization, for an initial period of years that allow for deferral of principal repayments. MTA loans generally have a date when the

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mortgage is recast to require principal payments under new terms, which can result in substantial increases in monthly payments to the borrower. Additionally, during the third quarter of 2008 there were significant negative ratings actions and unprecedented and sustained categorical asset price declines most notably in the mortgage-related securities backed by Alt-A loans, including MTA loans, in our portfolio. The combination of all of these factors not only had a material, negative impact on our view of expected performance in the third quarter, but also significantly reduced the likelihood of more favorable outcomes, resulting in a substantial increase in other-than-temporary impairments in the third quarter of 2008. Our aggregate losses on trading securities, our guarantee asset and derivatives, net of the unrealized gains on foreign-currency denominated debt, increased from $481 million in the second quarter of 2008 to $4.2 billion in the third quarter of 2008, as the turmoil in the markets contributed to dislocations in the normal correlations between different instruments. In our capacity as securities administrator for our issued securities, we also incurred a $1.1 billion loss in the third quarter of 2008 related to investments in short-term unsecured loans as a result of Lehman's bankruptcy. We determined it was necessary to establish a partial valuation allowance against our deferred tax assets due to the rapid deterioration of market conditions discussed above, the uncertainty of future market conditions on our results of operations and the uncertainty surrounding our future business model as a result of our placement into conservatorship by FHFA on September 6, 2008. These and other factors led us to record a non-cash charge of $14.3 billion in the third quarter of 2008 in order to establish a partial valuation allowance against our deferred tax asset. As a result, at September 30, 2008, we had a net deferred tax asset of $11.9 billion representing the tax effect of unrealized losses on our available-for-sale securities portfolio. Each of these drivers of our third quarter results is discussed in more detail below within "GAAP Results" and our "CONSOLIDATED RESULTS OF OPERATIONS". Credit Overview The factors affecting all residential mortgage market participants during 2008 have continued to adversely impact our

single-family mortgage portfolio during the third quarter of 2008. The following statistics illustrate the credit deterioration of loans in our single-family mortgage portfolio, which consists of single-family mortgage loans in our retained portfolio and those backing our guaranteed PCs and Structured Securities. Table 1 -- Credit Statistics, Single-Family Mortgage Portfolio(1)

	As of				
	09/30/2008	06/30/2008	03/31/2008	12/31/2007	09/30/2007
Delinquency rate (in basis points, or bps)(2)	122	93	77	65	51
Non-performing assets (in millions)(3)	$ 35,497	$ 27,480	$ 22,379	$ 18,121	$ 13,118
REO inventory (in units)	28,089	22,029	18,419	14,394	11,916
	For the Three Months Ended				
	09/30/2008	06/30/2008	03/31/2008	12/31/2007	09/30/2007
	(in units, unless noted)				
Loan modifications(4)	8,316	4,827	4,246	2,272	1,752
REO acquisitions	15,880	12,410	9,939	7,284	5,905
REO disposition severity ratio(5)	29.3%	25.2%	21.4%	18.1%	14.1%
Single-family credit losses (in millions)(6)	$ 1,270	$ 810	$ 528	$ 236	$ 122

(1) Consists of single-family mortgage loans for which we actively manage credit risk, which are those loans held in our retained portfolio as well as those loans underlying our PCs and Structured Securities, excluding Structured Transactions and that portion of our Structured Securities that are backed by Government National Mortgage Association, or Ginnie Mae, Certificates.
(2) We report single-family delinquency rate information based on the number of loans that are 90 days or more past due and those in the process of foreclosure. Mortgage loans whose contractual terms have been modified under agreement with the borrower are not included if the borrower is less than 90 days delinquent under the modified terms. See "CREDIT RISKS -- Credit Performance -- Delinquencies" for further information.
(3) Includes those loans in our single-family mortgage portfolio, based on unpaid principal balances, that are past due for 90 days or more or where contractual terms have been modified as a troubled debt restructuring. Also includes single-family real estate owned, or REO, which are acquired principally through foreclosure on loans within our single-family mortgage portfolio.
(4) Consist of modifications under agreement with the borrower. Excludes forbearance agreements, which are made in certain circumstances and under which reduced or no payments are required during a defined period as well as repayment plans, which are separate agreements with the borrower to repay past due amounts and return to compliance with the original terms.
(5) Calculated as the aggregate amount of our losses recorded on disposition of REO properties during the respective quarterly period divided by the aggregate unpaid principal balances of the related loans with the borrowers. The amount of losses recognized on disposition of the properties is equal to the amount by which the unpaid principal balance of loans exceeds the amount of gross sales proceeds from disposition of the properties. Excludes other related credit losses, such as property maintenance and selling expenses, as well as related recoveries from credit enhancements, such as mortgage insurance.
(6) Consists of REO operations expense plus charge-offs, net of recoveries from

third-party insurance and other credit enhancements. See "CREDIT RISKS -- Credit Performance -- Credit Loss Performance" for further information.

As the table above illustrates, we experienced continued deterioration in the performance of our single-family mortgage portfolio. Certain loan groups of the single-family mortgage portfolio, such as Alt-A and interest-only loans, as well as 2006 and 2007 vintage loans, are the main contributors to our worsening credit statistics. These loan groups have been affected by certain macro-economic factors, such as recent declines in home prices, which have resulted in erosion in the borrower's equity. These loan groups are also concentrated in the West region. The West region comprised 26% of the unpaid principal balances of our single-family mortgage portfolio as of September 30, 2008, but accounted for 48% and 43% of our REO

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acquisitions in the third and second quarters of 2008, respectively. Alt-A loans, which represented 10% of our single-family mortgage portfolio as of September 30, 2008, accounted for approximately 50% of our credit losses for the nine months ended September 30, 2008. In addition, stressed markets in the West region (especially California, Arizona and Nevada) and Florida tend to have higher average loan balances than the rest of the U.S. and were most affected by the steep home price declines. As we continue to experience home price declines in these and other regions, the severity of our single-family credit losses will continue to increase, as evidenced by our REO disposition severity ratio. As of September 30, 2008, single-family mortgage loans in the state of Florida comprise 7% of our single-family mortgage portfolio; however the loans in this state make up more than 20% of the total delinquent loans in our single-family mortgage portfolio, based on unpaid principal balances. Consequently, Florida remains our leading state for serious delinquencies, although these have not yet evidenced themselves in REO acquisitions or our credit losses due to the duration of Florida's foreclosure process. California and Arizona were the states with the highest credit losses in the third quarter of 2008 with 44% of our single-family credit losses on a combined basis. These and other factors caused us to significantly increase our estimate for loan loss reserves during the third quarter of 2008. In an effort to mitigate our losses and the continued growth of non-performing assets, we continue to expand our efforts to increase our foreclosure alternatives. Due to the overall deterioration in the mortgage credit environment, our loss mitigation activity has increased, as exemplified by our increased volumes of loan modifications in 2008. We are continuing to implement and develop strategies designed to mitigate the increase in our credit losses, including a recently announced program by our Conservator to expedite the modification process for certain troubled borrowers. Our non-agency securities in our retained portfolio, which are primarily backed by subprime, Alt-A and MTA mortgage loans, also continue to be affected by the deteriorating credit conditions during 2008. The table below illustrates the changes in delinquencies that are 60 days or more past due within our non-agency mortgage-related securities portfolio backed by subprime, Alt-A, and MTA loans in our retained portfolio. Increases in delinquencies that are 60 days or more past due do not fully reflect the recent poor performance of these securities as cumulative losses are also growing considerably more rapidly. Given the recent unprecedented deterioration in the economic outlook and the renewed acceleration of housing price declines, future performance of the loans backing these securities could continue to deteriorate. Table 2 -- Credit Statistics, Non-Agency Mortgage-Related Securities Backed by Subprime, Alt-A and MTA Loans

	As of				
	09/30/2008	06/30/2008	03/31/2008	12/31/2007	09/30/2007
Delinquency rates:					
Non-agency mortgage-related securities backed by:					
Subprime 1st Lien	35%	31%	27%	21%	16%
Alt-A(1)	14%	12%	10%	8%	5%
MTA	24%	18%	12%	7%	4%
Cumulative loss:					
Non-agency mortgage-related securities backed by:					
Subprime 1st Lien	4%	2%	1%	1%	1%
Alt-A(1)	1%	0%	0%	0%	0%
MTA	1%	0%	0%	0%	0%
Gross unrealized losses, pre-tax (in millions)	$ 22,411	$ 25,858	$ 28,065	$ 11,127	$ 2,993
Impairment loss for the three months ended (in millions)	$ 8,856	$ 826	--	--	--

(1) Exclude non-agency mortgage-related securities backed by other loans primarily comprised of securities backed by home equity lines of credit.

We held unpaid principal balances of $125.7 billion of non-agency mortgage-related securities backed by subprime and Alt-A and other loans in our retained portfolio as of September 30, 2008 compared to $152.6 billion as of December 31, 2007. We recognized impairment losses on these securities of $8.9 billion for the three months ended September 30, 2008. We had gross unrealized losses, net of tax, on these securities totaling $14.6 billion and $7.2 billion at September 30, 2008 and December 31, 2007, respectively. The increase in unrealized losses, despite the decline in unpaid principal balance, is due to the significant declines in non-agency mortgage asset prices which occurred during 2008 and which accelerated significantly for Alt-A and other loans, including MTA loans, during the third quarter of 2008. We believe the majority of the declines in the fair value of these securities are attributable to decreased liquidity and larger risk premiums in the mortgage market. See "CONSOLIDATED BALANCE SHEETS ANALYSIS -- Retained Portfolio" for further information. GAAP Results Summary of Financial Results for the Three Months Ended September 30, 2008 Net loss was $25.3 billion and $1.2 billion for the three months ended September 30, 2008 and 2007, respectively. Net loss increased in the three months ended September 30, 2008 compared to the same period of 2007, principally due to the establishment of a partial valuation allowance on our deferred tax asset, increased losses on investment activities, increased derivative losses, increased losses on our guarantee asset as well as increased credit-related expenses, which consist of the provision for credit losses and REO operations expense. In the third quarter of 2008, we recorded a non-cash charge of

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$14.3 billion related to the establishment of a partial valuation allowance against our deferred tax asset. The valuation allowance excludes the portion of the deferred tax asset representing the tax effect of unrealized losses on available-for-sale securities recorded in accumulated other comprehensive income, or AOCI, which management has the intent and ability to hold until recovery of the unrealized loss amounts. See "CONSOLIDATED BALANCE SHEETS ANALYSIS -- Deferred Tax Asset" for further information. These loss and expense items for the three months ended September 30, 2008 were partially offset by: (a) higher net interest income and income on guarantee obligation; (b) unrealized gains on foreign-currency denominated debt recorded at fair value; (c) lower losses on certain credit guarantees; and (d) lower losses on loans purchased due principally to changes in our operational practice of purchasing delinquent loans out of PC securitization pools in December 2007. As a result of the net loss, at September 30, 2008, our liabilities exceeded our assets under GAAP by $(13.7) billion while our stockholders' equity (deficit) totaled $(13.8) billion. The Director of FHFA has submitted a request under the Purchase Agreement in the amount of $13.8 billion to Treasury. We expect to receive such funds by November 29, 2008. Net interest income was $1.8 billion for the three months ended September 30, 2008, compared to $761 million for the three months ended September 30, 2007. We held higher amounts of fixed-rate agency mortgage-related securities in our retained portfolio at significantly wider spreads relative to our funding costs during the three months ended September 30, 2008. The increase in net interest income and yield is also due to significantly lower short-term interest rates on our short-term borrowings and lower long-term interest rates on our long-term borrowings for the three months ended September 30, 2008. The combination of a higher proportion of short-term debt, together with a higher proportion of fixed-rate securities within our retained portfolio during a steep yield curve environment, contributed to the improvement in net interest income and net interest yield during the three months ended September 30, 2008. Non-interest income (loss) was $(11.3) billion for the three months ended September 30, 2008, compared to non-interest income of $117 million for the three months ended September 30, 2007. The decrease in non-interest income in the third quarter of 2008 was primarily due to higher losses on investment activity, increased derivative losses, net of related foreign-currency gains and higher losses on our guarantee asset, partially offset by increased income on our guarantee obligation and higher management and guarantee income. Increased losses on investment activity during the third quarter of 2008 were principally attributed to $9.1 billion of security impairments primarily recognized on available-for-sale non-agency mortgage-related securities backed by subprime and Alt-A and other loans during the third quarter of 2008. See "CONSOLIDATED BALANCE SHEET ANALYSIS -- Retained Portfolio" for additional information. Income on our guarantee obligation was $783 million and $473 million for the three months ended September 30, 2008 and 2007, respectively. The amortization of income on our guarantee obligation was accelerated in the third quarter of 2008 as compared to the third quarter of 2007 in order to match our economic release from risk on the pools of mortgage loans we guarantee. Management and guarantee income increased 16%, to $832 million for the three months ended September 30, 2008 from $718 million for the three months ended September 30, 2007. This reflects increases in the average balance of our PCs and Structured Securities of 11% on an annualized basis for the three months ended September 30, 2008, as compared to the average balance during the third quarter of 2007. This increase in management and guarantee income also reflects higher average fee rates for the three months ended September 30, 2008 compared to the third quarter of 2007. Non-interest expense for the three months ended September 30, 2008 and 2007 totaled $7.9 billion and $3.1 billion, respectively. This includes normal credit-related expenses of $6.0 billion and $1.4 billion for the three months ended September 30, 2008 and 2007, respectively. For the three months ended September 30, 2008, our provision for credit losses significantly increased due to continued credit deterioration in our single-family credit guarantee portfolio, primarily due to further increases in delinquency rates and higher severity of losses on a per-property basis. Credit deterioration has been largely driven by declines in home prices and regional economic conditions as well as the effect of a greater composition of interest-only and Alt-A mortgage products in the mortgage origination market that we have purchased or guaranteed. REO operations expense increased primarily as a result of an

increase in market-based write-downs of REO property due to the decline in home prices, coupled with higher volumes in REO inventory, particularly in the states of California, Florida, Arizona, Michigan and Nevada. Non-interest expense, excluding normal credit-related expenses, for the three months ended September 30, 2008 totaled $1.9 billion compared to $1.7 billion for the three months ended September 30, 2007. The increase in non-interest expense, excluding normal credit-related expenses, was primarily due to a loss of $1.1 billion during the third quarter of 2008, related to the investments in short-term, unsecured loans we made to Lehman in our role as securities administrator for certain trust-related assets offset by decreases in losses on certain credit guarantees and losses on loans purchased. We refer to these transactions with Lehman as the Lehman short-term lending transactions. For more information on the Lehman short-term lending transactions, see "CONSOLIDATED RESULTS OF OPERATIONS -- Securities Administrator Loss on Investment Activity." Losses on certain credit guarantees decreased to $2 million for the three months ended September 30, 2008, compared to $392 million for the three months ended September 30, 2007, due to the change in our method for determining the fair value of our newly-issued guarantee obligation upon adoption of Statement of Accounting Standards, or SFAS,

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No. 157, "Fair Value Measurements," or SFAS 157, effective January 1, 2008. Losses on loans purchased decreased to $252 million for the three months ended September 30, 2008, compared to $649 million for the three months ended September 30, 2007, due to changes in our operational practice of purchasing delinquent loans out of PC pools. See "CONSOLIDATED RESULTS OF OPERATIONS -- Non-Interest Expense -- Losses on Certain Credit Guarantees and -- Losses on Loans Purchased," for additional information on this change in our operational practice. Administrative expenses totaled $308 million for the three months ended September 30, 2008, down from $428 million for the three months ended September 30, 2007 primarily due to a reduction in our short-term performance compensation during the third quarter of 2008 as well as a decrease in our use of consultants throughout 2008. As a percentage of our average total mortgage portfolio, administrative expenses declined to 5.6 basis points for the three months ended September 30, 2008, from 8.7 basis points for the three months ended September 30, 2007. For the three months ended September 30, 2008 and 2007, we recognized effective tax rates of (46)% and 44%, respectively. See "NOTE 12: INCOME TAXES" to our consolidated financial statements for additional information about how our effective tax rate is determined. Summary of Financial Results for the Nine Months Ended September 30, 2008 Effective January 1, 2008, we adopted SFAS 157 which defines fair value, establishes a framework for measuring fair value in financial statements and expands required disclosures about fair value measurements. In connection with the adoption of SFAS 157, we changed our method for determining the fair value of our newly-issued guarantee obligations. Under SFAS 157, the initial fair value of our guarantee obligation equals the fair value of compensation received, consisting of management and guarantee fees and other upfront compensation, in the related securitization transaction, which is a practical expedient for determining fair value. As a result, prospectively from January 1, 2008, we no longer record estimates of deferred gains or immediate, "day one" losses on most guarantees. Our adoption of SFAS 157 did not result in an immediate recognition of gain or loss, but the prospective change had a positive impact on our financial results for the three and nine months ended September 30, 2008. Also effective January 1, 2008, we adopted SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115," or SFAS 159 or the fair value option, which permits companies to choose to measure certain eligible financial instruments at fair value that are not currently required to be measured at fair value in order to

mitigate volatility in reported earnings caused by measuring assets and liabilities differently. We initially elected the fair value option for certain available-for-sale mortgage-related securities and our foreign-currency denominated debt. Upon adoption of SFAS 159, we recognized a $1.0 billion after-tax increase to our retained earnings at January 1, 2008. We may continue to elect the fair value option for certain securities to mitigate interest-rate aspects of our guarantee asset and certain non-hedge designated pay-fixed swaps. Net loss was $26.3 billion and $642 million for the nine months ended September 30, 2008 and 2007, respectively. Net loss increased during the nine months ended September 30, 2008 compared to the same periods of 2007, principally due to the establishment of a partial valuation allowance against our deferred tax asset, increased losses on investment activity primarily related to impairment losses on certain non-agency mortgage-related securities, increased derivative losses, increased losses on guarantee asset as well as an increase in normal credit-related expenses, which consist of our provision for credit losses and REO operations expense. In the third quarter of 2008, we recorded a $14.3 billion non-cash charge related to the establishment of a partial valuation allowance against our deferred tax asset. The valuation allowance excludes the portion of the deferred tax asset representing the tax effect of unrealized losses on available-for-sale securities recorded in AOCI, which management has the intent and ability to hold until recovery of the unrealized loss amounts. These loss and expense items for the nine months ended September 30, 2008 were partially offset by higher net interest income and income on our guarantee obligation as well as lower losses on certain credit guarantees due to our use of the practical expedient for determining fair value under SFAS 157 and lower losses on loans purchased due to changes in our operational practice of purchasing delinquent loans out of PC securitization pools. Net interest income was $4.2 billion for the nine months ended September 30, 2008, compared to $2.3 billion for the nine months ended September 30, 2007. The 2% annualized limitation on the growth of our retained portfolio established by FHFA expired during March of 2008 as we became a timely filer of our financial statements. As a result, we were able to hold higher amounts of fixed-rate agency mortgage-related securities at significantly wider spreads relative to our funding costs during the nine months ended September 30, 2008. Non-interest income (loss) was $(10.4) billion and $1.6 billion for the nine months ended September 30, 2008 and 2007, respectively. The decrease in non-interest income in the 2008 period was primarily due to higher losses on investment activity, higher derivative losses excluding foreign-currency related effects, and higher losses on our guarantee asset. These losses were partially offset by increased income on our guarantee obligation and higher management and guarantee income in the 2008 period. Non-interest expense for the nine months ended September 30, 2008 and 2007 totaled $13.5 billion and $5.8 billion, respectively, and included normal credit-related expenses of $10.3 billion and $2.1 billion, respectively. Non-interest expense, excluding normal credit-related expenses, for the nine

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months ended September 30, 2008 and 2007 totaled $3.2 billion and $3.7 billion, respectively. The decline in non-interest expense, excluding normal credit-related expenses, was primarily due to the reductions in losses on certain credit guarantees and losses on loans purchased and was partially offset by the $1.1 billion loss on the Lehman short-term lending transactions. Administrative expenses totaled $1.1 billion for the nine months ended September 30, 2008, down from $1.3 billion for the nine months ended September 30, 2007. As a percentage of our average total mortgage portfolio, administrative expenses declined to 6.8 basis points for the nine months ended September 30, 2008, from 8.8 basis points for the nine months ended September 30, 2007. For the nine months ended September 30, 2008 and 2007, we recognized

effective tax rates of (33)% and 66%, respectively. See "NOTE 12: INCOME TAXES" to our consolidated financial statements for additional information about how our effective tax rate is determined. Segments We manage our business through three reportable segments subject to the conduct of our business under the direction of the Conservator, as discussed above under "Managing Our Business During Conservatorship -- Our Objectives.":

ù Investments;
ù Single-family Guarantee; and
ù Multifamily.

Certain activities that are not part of a segment are included in the All Other category. We manage and evaluate the performance of the segments and All Other using a Segment Earnings approach. Segment Earnings differs significantly from, and should not be used as a substitute for, net income (loss) as determined in accordance with GAAP. There are important limitations to using Segment Earnings as a measure of our financial performance. Among them, our regulatory capital measures are based on our GAAP results, as is the need to obtain funding under the Purchase Agreement. Segment Earnings adjusts for the effects of certain gains and losses and mark-to-fair-value items, which depending on market circumstances, can significantly affect, positively or negatively, our GAAP results and have in recent periods caused us to record significant GAAP net losses. GAAP net losses will adversely impact our GAAP stockholders' equity (deficit), as well as our need for funding under the Purchase Agreement, regardless of results reflected in Segment Earnings. For a summary and description of our financial performance on a segment basis, see "CONSOLIDATED RESULTS OF OPERATIONS -- Segment Earnings" and "NOTE 16: SEGMENT REPORTING" to our consolidated financial statements. In managing our business, we present the operating performance of our segments using Segment Earnings. Segment Earnings present our results on an accrual basis as the cash flows from our segments are earned over time. The objective of Segment Earnings is to present our results in a manner more consistent with our business models. The business model for our investment activity is one where we generally buy and hold our investments in mortgage-related assets for the long term, fund our investments with debt and use derivatives to minimize interest rate risk, thus generating net interest income in line with our return on equity objectives. We believe it is meaningful to measure the performance of our investment business using long-term returns, not short-term value. The business model for our credit guarantee activity is one where we are a long-term guarantor in the conforming mortgage markets, manage credit risk and generate guarantee and credit fees, net of incurred credit losses. As a result of these business models, we believe that this accrual-based metric is a meaningful way to present our results as actual cash flows are realized, net of credit losses and impairments. We believe Segment Earnings provides us with a view of our financial results that is more consistent with our business objectives and helps us better evaluate the performance of our business, both from period-to-period and over the longer term.

Table 3 presents Segment Earnings (loss) by segment and the All Other category and includes a reconciliation of Segment Earnings (loss) to net income (loss) prepared in accordance with GAAP. Table 3 -- Reconciliation of Segment Earnings (Loss) to GAAP Net Income (Loss)

TARP AIG SSFI Investment

Senior Preferred Stock and Warrant

Summary of Senior Preferred Terms

Issuer: American International Group, Inc. (“AIG”).

Initial Holder: United States Department of the Treasury (the “UST”).

Size: $40 Billion aggregate liquidation preference.

Security: Senior Preferred, liquidation preference $10,000 per share; provided that UST may, upon transfer of the Senior Preferred, require AIG to appoint a depositary to hold the Senior Preferred and issue depositary receipts.

Ranking: Senior to common stock and pari passu with existing preferred shares other than preferred shares which by their terms rank junior to the Senior Preferred. At the meeting of stockholders called to effect the amendments to AIG’s Restated Certificate of Incorporation contemplated by the terms of the convertible preferred stock, AIG shall propose an amendment to its Restated Certificate of Incorporation to allow the Senior Preferred to rank senior to the convertible preferred stock.

Term: Perpetual life.

Dividend: The Senior Preferred will accrue cumulative dividends at a rate of 10% per annum. Dividends will be payable quarterly in arrears on February 1, May 1, August 1 and November 1 of each year. Dividends will be payable when, as and if declared by the Board of Directors of AIG. Accrued but unpaid dividends shall compound quarterly.

Redemption: At any time that (i) the AIG Credit Facility Trust (or any successor entity established for the benefit of the United States Treasury) “beneficially owns” less than 30% of the aggregate voting power of AIG's voting securities and (ii) no holder of the Senior Preferred controls AIG, then AIG may redeem the Senior Preferred in whole or in part at a redemption price equal to 100% of its liquidation preference, plus an amount equal to accrued and unpaid dividends (including, if applicable, dividends on such amount). “Control” for this purpose means the power to direct the management and policies of AIG, directly or indirectly, whether through the ownership of voting securities, by contract, by the power to control AIG's Board of Directors or otherwise. “Beneficially owns” is as defined in Rule 13d-3 under the Securities Exchange Act of 1934. For the avoidance of doubt, while there is AIG’s Board of Directors control (or the potential to gain AIG’s Board of Directors control) by the holder of the Senior Preferred, then AIG is not permitted to redeem the Senior Preferred.

Restrictions on Dividends: Subject to certain exceptions, for as long as any Senior Preferred

is outstanding, no dividends may be declared or paid on junior preferred shares, preferred shares ranking pari passu with the Senior Preferred ("Parity Stock"), or common shares (other than (i) in the case of pari passu preferred shares, dividends on a pro rata basis with the Senior Preferred and (ii) in the case of junior preferred shares, dividends payable solely in common shares), nor may AIG repurchase or redeem any junior preferred shares, preferred shares ranking pari passu with the Senior Preferred or common shares, unless all accrued and unpaid dividends for all past dividend periods on the Senior Preferred are fully paid or declared and a sum sufficient for the payment thereof set apart.

Common dividends: The UST's consent shall be required for any increase in common dividends per share until the fifth anniversary of the date of this investment unless prior to such fifth anniversary the Senior Preferred is redeemed in whole or the UST has transferred all of the Senior Preferred to third parties.

Repurchases: The UST's consent shall be required for repurchases of any common shares, other capital stock, trust preferred securities or other equity securities (other than (i) repurchases of the Senior Preferred, (ii) repurchases of junior preferred shares or common shares ("Junior Stock") in connection with the administration of any employee benefit plan in the ordinary course of business and consistent with past practice (including purchases to offset share dilution pursuant to a publicly announced repurchase plan), (iii) any redemption or repurchase of rights pursuant to any stockholders' rights plan and (iv) the exchange or conversion of Junior Stock for or into other Junior Stock or of Parity Stock or trust preferred securities for or into other Parity Stock (with the same or lesser aggregate liquidation amount) or Junior Stock, in each case, solely to the extent required pursuant to binding contractual agreements entered into prior to the signing date of UST's agreement to purchase the Senior Preferred or any subsequent agreement for the accelerated exercise, settlement or exchange thereof for common stock), until the fifth anniversary of the date of this investment unless prior to such fifth anniversary the Senior Preferred is redeemed in whole or the UST has transferred all of the Senior Preferred to third parties. Notwithstanding the foregoing, following the redemption in whole of the Senior Preferred held by UST or the transfer by UST of all of the Senior Preferred to one or more third parties not affiliated with UST, AIG may repurchase, in whole or in part, at any time the Warrant then held by UST at the fair market value of the Warrant so long as no holder of the Warrant controls AIG as provided in clause (ii) of "Redemption" above.

Voting rights: The Senior Preferred shall be non-voting, other than class voting rights on (i) any authorization or issuance of shares other than the convertible preferred stock ranking senior or pari passu to the Senior Preferred, (ii) any amendment that adversely affects the rights of Senior Preferred, or (iii) any merger, exchange or similar transaction unless the Senior Preferred remains outstanding or is converted into or exchanged for preference securities of the surviving or resulting entity or its ultimate parent and the Senior Preferred or such preference shares have such rights, preferences, privileges and voting powers, and limitations and restrictions thereof, taken as a whole, as are not materially less

favorable to the holders thereof than those of the Senior Preferred immediately prior to such transaction, taken as a whole.

If dividends on the Senior Preferred are not paid in full for four dividend periods, whether or not consecutive, the Senior Preferred will have the right to elect the greater of 2 directors and a number of directors (rounded upward) equal to 20% of the total number of directors after giving effect to such election. The right to elect directors will end when full dividends have been paid for all past dividend periods.

Transferability: The Senior Preferred will not be subject to any contractual restrictions on transfer other than such as are necessary to insure compliance with U.S. federal and state securities laws. AIG will file a registration statement (which may be a shelf registration statement) covering the Senior Preferred as promptly as practicable, but in any event within 15 days, after notification by the UST and, if necessary, shall take all action required to cause such registration statement to be declared effective as soon as possible. During any period that an effective registration statement is not available for the resale by the UST of the Senior Preferred, AIG will also grant to the UST piggyback registration rights for the Senior Preferred and will take such other steps as may be reasonably requested to facilitate the transfer of the Senior Preferred including, if requested by the UST, using reasonable best efforts to list the Senior Preferred on a national securities exchange. If requested by the UST, AIG will appoint a depositary to hold the Senior Preferred and issue depositary receipts.

Claim in Bankruptcy: Equity claim with liquidation preference to common equity claim.

Acceleration Rights: None

Use of Proceeds: To repay the senior secured revolving credit facility governed by the Credit Agreement dated as of September 22, 2008 (the “Credit Agreement”) between AIG and the Federal Reserve Bank of New York (“FRBNY”).

Tax Treatment: Dividends on the Senior Preferred are non tax-deductible to AIG.

Restrictions on Expenses: AIG shall continue to maintain and implement its comprehensive written policy on corporate expenses and distribute such policy to all AIG employees. Such policy, as may be amended from time to time, shall remain in effect at least until such time as any of the shares of the Senior Preferred are owned by the UST. Any material amendments to such policy shall require the prior written consent of the UST until such time as the UST no longer owns any shares of Senior Preferred, and any material deviations from such policy, whether in contravention thereof or pursuant to waivers provided for thereunder, shall promptly be reported to the UST. Such policy shall, at a minimum: (i) require compliance with all applicable law; (ii) apply to AIG and all of its subsidiaries; (iii) govern (a) the hosting, sponsorship or other

payment for conferences and events, (b) the use of corporate aircraft, (c) travel accommodations and expenditures, (d) consulting arrangements with outside service providers, (e) any new lease or acquisition of real estate, (f) expenses relating to office or facility renovations or relocations and (g) expenses relating to entertainment or holiday parties; and (iv) provide for (a) internal reporting and oversight and (b) mechanisms for addressing non-compliance with the policy.

Restrictions on Lobbying: AIG shall continue to maintain and implement its comprehensive written policy on lobbying, governmental ethics and political activity and distribute such policy to all AIG employees and lobbying firms involved in any such activity. Such policy, as may be amended from time to time, shall remain in effect at least until such time as any of the shares of the Senior Preferred are owned by the UST. Any material amendments to such policy shall require the prior written consent of the UST until such time as the UST no longer owns any shares of Senior Preferred, and any material deviations from such policy, whether in contravention thereof or pursuant to waivers provided for thereunder, shall promptly be reported to the UST. Such policy shall, at a minimum: (i) require compliance with all applicable law; (ii) apply to AIG and all of its subsidiaries and affiliated foundations; (iii) govern (a) the provision of items of value to any government officials, (b) lobbying and (c) political activities and contributions; and (iv) provide for (a) internal reporting and oversight and (b) mechanisms for addressing non-compliance with the policy.

Reporting: Except as otherwise agreed, AIG shall provide the UST (i) the information required to be provided by AIG to the FRBNY pursuant to Section 5.04 of the Credit Agreement, (ii) the notices required by Section 5.05 of the Credit Agreement, in each case within the time periods for delivery thereof specified in the Credit Agreement and (iii) such executive compensation information as is required for purposes of the Emergency Economic Stabilization Act of 2008 (“EESA”) and the regulations and guidelines thereunder; provided that, after the termination of the Credit Agreement, such informational and notice requirements as are provided in Section 5.04 and Section 5.05 of the Credit Agreement shall remain in full force and effect until such time as the UST no longer owns any shares of Senior Preferred. In addition, AIG shall promptly provide the UST such other information and notices as the UST may reasonably request from time to time.

Executive Compensation: As a condition to the closing of this investment, AIG shall be subject to the executive compensation and corporate governance requirements of Section 111(b) of the EESA and the UST’s guidelines that carry out the provisions of such subsection for systemically significant failing institutions as set forth in Notice 2008-PSSFI. Accordingly, as a condition to the closing of this investment, AIG and its senior executive officers covered by the EESA (“SEOs”) shall modify or terminate all benefit plans, arrangements and agreements (including golden parachute agreements) to the extent necessary to be in compliance with,

and following the closing and for so long as the UST holds any equity or debt securities of AIG issued under this agreement (the "Relevant Period"), AIG shall agree to be bound by the executive compensation and corporate governance requirements of Section 111(b) of the EESA and the guidelines set forth in Notice 2008-PSSFI. As an additional condition to the closing, AIG and its SEOs shall grant to the UST and the SEOs shall grant to AIG waivers releasing the UST, and, in the case of the SEOs release, AIG, from any claims that AIG and such SEOs may otherwise have as a result of any modification of the terms of any benefit plans, arrangements and agreements to eliminate any provisions that would not be in compliance with the executive compensation and corporate governance requirements of Section 111 of the EESA and the guidelines set forth in Notice 2008-PSSFI.

In addition to Notice 2008-PSSFI, the following will apply:

1. AIG shall undertake during the Relevant Period to limit any golden parachute payments to its most senior employee group, who are currently referred to as Senior Partners ("Senior Partners"), (other than its SEOs) to the amounts permitted by the regulations relating to participants in the EESA Capital Purchase Program and the guidelines and Interim Final Rule (31 CFR Part 30) relating thereto as if they were SEOs (except that equity denominated awards settled solely in equity shall not be included in such limit), and AIG shall grant the UST a waiver releasing the UST, and shall use its best efforts to obtain waivers from the Senior Partners releasing the UST and AIG, from claims that AIG may have against the UST and that such Senior Partners may have against the UST or AIG as a result of such limits, and shall have obtained such waivers from AIG and its U.S.-based Senior Partners prior to and as an additional condition to the closing.

2. The annual bonus pools payable to Senior Partners in respect of each of 2008 and 2009 shall not exceed the average of the annual bonus pools paid to Senior Partners for 2006 and 2007 (in each case exclusive of AIG's historic quarterly bonus program, the amount of which will not increase for any participant, and subject to appropriate adjustment for new hires and departures).

Risk Management Committee: AIG shall establish, within 30 days of the issuance of the Senior Preferred, and maintain, at least until the UST ceases to own any shares of the Senior Preferred, the Warrant or any other equity or debt securities of AIG, a risk management committee of the AIG's Board of Directors that will oversee the major risks involved in AIG's business operations and review AIG's actions to mitigate and manage those risks.

Miscellaneous: The dividend rate as provided in "Dividend" above is subject to adjustment in the sole discretion of the Secretary of the Treasury in light of, inter alia, then-prevailing economic conditions and the financial condition of AIG, with the objective of protecting the U.S. taxpayer.

Summary of Warrant Terms

Warrant: The UST will receive a warrant ("Warrant") to purchase a number of shares of common stock of AIG ("Common Stock") equal to 2% of the issued and outstanding shares of Common Stock on the date of investment. The initial exercise price for the Warrant shall be $2.50 per share of Common Stock (representing the par value of the Common Stock on the date of the investment), subject to customary anti-dilution adjustments; provided that the initial exercise price per share of Common Stock shall be adjusted to the par value per share of the Common Stock following the amendments to AIG's Restated Certificate of Incorporation contemplated by the terms of the convertible preferred stock. The Warrant shall be net share settled or, if consented to by AIG and the UST, on a full physical basis.

Term: 10 years

Exercisability: Immediately exercisable, in whole or in part.

Transferability: The Warrant will not be subject to any contractual restrictions on transfer other than such as are necessary to ensure compliance with U.S. federal and state securities laws. AIG will file a registration statement (which may be a shelf registration statement) covering the Warrant and the Common Stock underlying the Warrant as promptly as practicable, but in any event within 15 days after notification by the UST, and, if necessary, shall take all action required to cause such registration statement to be declared effective as soon as possible. During any period that an effective registration statement is not available for the resale by the UST of the Warrant or the Common Stock underlying the Warrant, AIG will also grant to the UST piggyback registration rights for the Warrant and the Common Stock underlying the Warrant. AIG will apply for the listing on the New York Stock Exchange of the Common Stock underlying the Warrant and will take such other steps as may be reasonably requested to facilitate the transfer of the Warrant and the underlying Common Stock.

Voting: The UST will agree not to exercise voting power with respect to any shares of Common Stock issued to it upon exercise of the Warrant.

Substitution: In the event AIG is no longer listed or traded on a national securities exchange the Warrant will be exchangeable (in whole or in part), at the option of the UST, for an economic interest (to be determined by the UST after consultation with AIG) of AIG classified as permanent equity under GAAP having a fair market value (as determined by the UST) equal to the portion of the Warrant so exchanged.

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6035

C. K. Lee
Complex and International Organizations

March 10, 2008

American International Group, Inc.
Attention: Anastasia D. Kelly, Executive Vice President, General Counsel and Senior Regulatory and Compliance Officer
70 Pine Street, 27th Floor
New York, NY 10270

Members of the Board:

I am writing to inform you that the disclosures contained in the Form 8K filed on February 11, 2008 by American International Group, Inc., (AIG), supplemented by discussions with Price Waterhouse Coopers (PwC) and AIG management raise supervisory concerns regarding the corporate oversight of key AIG subsidiaries. Recent discussions also indicate that these concerns are shared by other functional supervisors of AIG. We are concerned that the corporate oversight of AIG Financial Products (AIGFP), International Lease Finance Corporation (ILFC), and American General Finance, Inc. (AGF) lacks critical elements of independence, transparency, and granularity.

A material weakness exists within corporate management's oversight of AIGFP's super senior Credit Default Swap (CDS) valuation process and financial reporting. Recent supervisory review work and discussions with PwC indicate that AIGFP was allowed to limit access of key risk control groups while material questions relating to the valuation of the super senior CDS portfolio were mounting. The control groups included Enterprise Risk Management (ERM), the Corporate Comptroller's Group, and the CFO of the Financial Services Division.

The super senior CDS valuations reviewed by corporate management lacked the accuracy and granularity necessary to understand the impact of key valuation components on AIG's accounting and financial reporting disclosures. Corporate management did not obtain sufficient information to completely assess the applicability of the negative basis adjustment, a critical component of the valuation method. In view of this occurrence and the observed similarity in reporting by other key subsidiaries, we are concerned that risk metrics and financial reporting provided to corporate management by AIGFP and other key subsidiaries may lack the independence, transparency, and granularity needed to provide effective risk management oversight.

We note that two business units, AGF and AIGFP, limited their exposures to subprime markets in view of deteriorating market conditions, while two other units, United Guaranty Corporation and AIG Investments, increased their subprime exposures. The lack of a cohesive mechanism to share information on subprime exposures leads to incomplete central oversight across the conglomerate.

In light of the identified material weakness in the oversight of the valuation of the super senior CDS portfolio, and gaps noted within corporate oversight, we have downgraded AIG's holding company Risk Management, or "R" CORE component rating.

. Risk management practices need improvement to ensure that management and the board are fully able to identify, monitor, and control all significant risks.

We have downgraded AIG's holding company Earnings "E" CORE component rating

This action reflects our supervisory concern with the high degree of earnings volatility that currently exists due to the holding company's exposure to the US subprime market. Though we also acknowledge the demonstrated earnings strength of the holding company to absorb material unanticipated losses, the significant negative impact to earnings from the super senior CDS portfolio valuation adjustment, combined with the portfolio's potential to significantly impact future earnings, are of increased supervisory concern.

We have also downgraded AIG's holding company Composite rating

Given the seriousness of this matter, please respond by providing a corrective action plan to address our concerns contained in this letter. The following elements will be important factors in our assessment of your corrective action plan: (1) correction of all control weaknesses over financial reporting relating to valuation methods; (2) demonstrated improvement of central corporate oversight of AIG's key subsidiaries including AIGFP, ILFC, and AGF; (3) meaningful benchmarks to measure the effectiveness of corrective actions; and (4) monthly progress reports. Please provide your written response and the corrective action plan to OTS no later than 30 days following receipt of this letter.

This letter is provided to the holding company for its confidential use. Except as provided in 12 C.F.R. Section 510.5, the holding company, its directors, officers, or employees may not disclose this letter, or any portion of it, to unauthorized persons or organizations. Unauthorized persons or organizations include anyone not officially connected with the holding company as an officer, director, employee, attorney, auditor, independent auditor, subsidiary institution, or affiliated holding company.

If the holding company receives a subpoena or other legal process calling for production of this document, notify the Managing Director, Complex and International Organizations immediately. Advise the attorney and, if necessary, the court of the above prohibition and refer them to 12 C.F.R. Section 510.5.

If you have any questions, please call me at [redacted]. If I am unavailable, please call Alexandria Luk, Acting Director, Conglomerate Operations at [redacted]

Sincerely,

C.K. Lee
Managing Director, Complex & International Organizations

Attachment:
Federal Register Notice, OTS Savings and Loan Holding Company Rating System

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's Discussion and Analysis of Financial Condition and Results of Operations is designed to provide the reader a narrative with respect to AIG's operations, financial condition and liquidity and certain other significant matters.

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Cautionary Statement Regarding Projections and Other Information About Future Events

This Quarterly Report on Form 10-Q and other publicly available documents may include, and AIG's officers and representatives may from time to time make, projections concerning financial information and statements concerning future economic performance and events, plans and objectives relating to the establishment of special purpose vehicles with the NY Fed, asset dispositions, liquidity, collateral posting requirements, management, operations, products and services, and assumptions underlying these projections and statements. These projections and statements are not historical facts but instead represent only AIG's belief regarding future events, many of which, by their nature, are inherently uncertain and outside AIG's control. These projections and statements may address, among other things, the number, size, terms and timing of dispositions and their potential effect on AIG's businesses, financial condition, results of operations, cash flows and liquidity (and AIG at any time and from time to time may change its plans with respect to the sale of one or more businesses), the effect on AIG's liquidity of the establishment of two special purpose vehicles with the NY Fed, AIG's exposures to subprime mortgages, monoline insurers and the residential and commercial real estate markets and AIG's strategy for growth, product development, market position, financial results and reserves. It is possible that AIG's actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in these projections and statements. Factors that could cause AIG's actual results to differ, possibly materially, from those in the specific projections and statements are discussed in Risk Factors, and throughout this Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) and in Item 1A. Risk Factors of this Quarterly Report on Form 10-Q and Item 1A. Risk Factors of AIG's Annual Report on Form 10-K for the year ended December 31, 2007 (2007 Annual Report on Form 10-K). AIG is not under any obligation (and expressly disclaims any such obligations) to update or alter any projection or other statement, whether written or oral, that may be made from time to time, whether as a result of new information, future events or otherwise.

In addition to reviewing AIG's results for the three and nine months ended September 30, 2008, this MD&A supplements and updates the information and discussion included in the 2007 Annual Report on Form 10-K to reflect developments in or affecting AIG's business to date during 2008. Throughout this MD&A, AIG presents its operations in the way it believes will be most meaningful. Statutory loss ratios and combined ratios are presented in accordance with accounting principles prescribed by insurance regulatory authorities because these are standard measures of performance filed with insurance regulatory authorities and used for analysis in the insurance industry and thus allow more meaningful comparisons with AIG's insurance competitors. AIG also uses cross-references to additional information included in this Quarterly Report on Form 10-Q and in the 2007 Annual Report on Form 10-K to assist readers seeking related information on a particular subject.

Consideration of AIG's Ability to Continue as a Going Concern

In connection with the preparation of its third quarter Form 10-Q, management has assessed whether AIG has the ability to continue as a going concern. In making this assessment, AIG has considered:

- The liquidity events leading up to September 22, 2008;
- AIG's liquidity-related actions and plans to stabilize its businesses and repay the facility (Fed Facility) created pursuant to the $85 billion credit agreement, dated September 22, 2008 (Fed Credit Agreement), between AIG and the Federal Reserve Bank of New York (NY Fed);
- The negative effects of the liquidity events on AIG's businesses and AIG's efforts to address such effects; and
- The substantial risks to which AIG is subject.

Each of these items is discussed in more detail below.

In considering these items, management has made significant judgments and estimates with respect to the potentially adverse financial and liquidity effects of AIG's risks and uncertainties. Management has also assessed other items and risks arising in AIG's businesses and made reasonable judgments and estimates with respect thereto. After consideration, management believes that it will have adequate liquidity to finance and operate AIG's businesses and continue as a going concern for at least the next twelve months.

It is possible that the actual outcome of one or more of management's plans could be materially different or that one or more of management's significant judgments or estimates about the potential effects of the risks and uncertainties could be prove to be materially incorrect or that the principal transactions disclosed in Note 11 to the Consolidated Financial Statements (and as discussed below) do not result in completed transactions. If one or more of these possible outcomes were realized, AIG may not have sufficient cash to meet its obligations. If AIG needs funds in excess of amounts available from the sources described below, AIG would need to find additional financing and, if such additional financing were to be unavailable, there could be substantial doubt about AIG's ability to continue as a going concern.

Liquidity Events Leading Up to September 22, 2008

Liquidity Entering the Third Quarter

AIG parent entered the third quarter of 2008 with $17.6 billion of cash and cash equivalents, including the remaining proceeds from the issuance of $20 billion of common stock, equity units, and junior subordinated debt securities in May 2008. In addition, AIG's securities lending collateral pool held $10.4 billion of cash and other short-term investments. On August 18, 2008, AIG raised $3.25 billion through the issuance of 8.25% Notes Due 2018.

Strategic Review and Proposed Liquidity Measures

From mid-July and throughout August 2008, AIG's then Chief Executive Officer, Robert Willumstad, was engaged in a review of AIG's businesses. Mr. Willumstad had announced that he would hold an investor meeting on September 25, 2008 to present the results of his review.

During this same time period, AIG was engaged in a review of measures to address the liquidity concerns in AIG's securities lending portfolio discussed in previous SEC filings and to address the ongoing collateral calls with respect to AIGFP's super senior multi-sector credit default swap portfolio. To facilitate this process, AIG asked a number of investment banking firms to discuss possible solutions to these issues. In late August, AIG engaged J.P. Morgan Securities, Inc. (J.P. Morgan) to assist in developing alternatives, including a potential additional capital raise.

Continuing Liquidity Pressures

Under AIG's securities lending program, cash collateral is received from borrowers and invested by AIG primarily in fixed maturity securities to earn a spread. Historically, AIG had received cash collateral from borrowers of 100-102 percent of the value of the loaned securities. In light of more favorable terms offered by other lenders of securities, AIG accepted cash advanced by borrowers of less than the 102 percent historically required by insurance regulators. Under an agreement with its insurance company subsidiaries participating in the securities lending program, AIG parent deposited collateral in an amount sufficient to address the deficit. AIG parent also deposited amounts into the collateral pool to offset losses realized by the pool in connection with sales of impaired securities. Aggregate deposits by AIG parent to or for the benefit of the securities lending collateral pool through August 31, 2008 totaled $3.3 billion.

In addition, from July 1, 2008 to August 31, 2008, the continuing decline in value of the super senior collateralized debt obligations (CDO) securities protected by AIGFP's super senior credit default swap portfolio, together with ratings downgrades of such CDO securities, resulted in AIGFP posting or agreeing to post collateral in an aggregate net amount of $6.0 billion.

By the beginning of September 2008, these collateral postings and securities lending requirements were placing increasing stress on AIG parent's liquidity.

Rating Agencies

In early September 2008, AIG met with the representatives of the principal rating agencies to discuss Mr. Willumstad's

strategic review as well as the liquidity issues arising from AIG's securities lending program and AIGFP's super senior multi-sector CDO credit default swap portfolio. On Friday, September 12, 2008, S&P placed AIG on CreditWatch with negative implications and noted that upon completion of its review, the agency could affirm AIG parent's current rating of "AA-" or lower the rating by one to three notches. AIG understood that both S&P and Moody's would re-evaluate AIG's ratings early in the week of September 15, 2008. Also on Friday, September 12, 2008, AIG's subsidiaries ILFC and AGF were unable to replace all of their maturing commercial paper with new issuances of commercial paper. As a result, AIG advanced loans to these subsidiaries to meet their commercial paper obligations.

The Accelerated Capital Raise Attempt

As a result of S&P's action, AIG accelerated the process of attempting to raise additional capital and over the weekend of September 13 and 14, 2008 discussed potential capital injections and other liquidity measures with private equity firms, sovereign wealth funds and other potential investors. AIG kept the United States Treasury and the NY Fed informed of these efforts. AIG also engaged Blackstone Advisory Services LP to assist in developing alternatives, including a potential additional capital raise. Despite offering a number of different structures through this process, AIG did not receive a proposal it could act upon in a timely fashion. AIG's difficulty in this regard resulted in part from the dramatic decline in its common stock price from $22.76 on September 8, 2008 to $12.14 on September 12, 2008. This decrease in stock price made it unlikely that AIG would be able to raise the large amounts of capital that would be necessary if AIG's long-term debt rating were downgraded.

AIG Attempts to Enter into a Syndicated Secured Lending Facility

On Monday, September 15, 2008, AIG was again unable to access the commercial paper market for its primary commercial paper programs, AIG Funding, ILFC and AGF. Payments under the programs totaled $2.2 billion for the day, and AIG advanced loans to ILFC and AGF to meet their funding obligations. In addition, AIG experienced returns under its securities lending programs which led to cash payments of $5.2 billion to securities lending counterparties on that day.

On Monday morning, September 15, 2008, AIG met with representatives of Goldman, Sachs & Co., J.P. Morgan and the NY Fed to discuss the creation of a $75 billion secured lending facility to be syndicated among a number of large financial institutions. The facility was intended to act as a bridge loan to meet AIG parent's liquidity needs until AIG could sell sufficient assets to stabilize and enhance its liquidity position. Goldman, Sachs & Co. and J.P. Morgan immediately began the syndication attempt.

The Rating Agencies Downgrade AIG's Long-Term Debt Rating

In the late afternoon of September 15, 2008, S&P downgraded AIG's long-term debt rating by three notches, Moody's downgraded AIG's long-term debt rating by two notches and Fitch downgraded AIG's long-term debt rating by two notches. As a consequence of the rating actions, AIGFP estimated that it would need in excess of $20 billion in order to fund additional collateral demands and transaction termination payments in a short period of time. Subsequently, in a period of approximately 15 days following the rating actions, AIGFP was required to fund approximately $32 billion, reflecting not only the effect of the rating actions but also changes in market levels and other factors.

The Private Sector Solution Fails

By Tuesday morning, September 16, 2008, it had become apparent that Goldman, Sachs & Co. and J.P. Morgan were unable to syndicate a lending facility. Moreover, the downgrades combined with a steep drop in AIG's common stock price to $4.76 on September 15, 2008, had resulted in counterparties withholding payments from AIG and refusing to transact with AIG even on a secured short-term basis. As a result, AIG was unable to borrow in the short-term lending markets. To provide liquidity on Tuesday, September 16, 2008, both ILFC and AGF drew down on their revolving credit facilities, resulting in borrowings of approximately $6.5 billion and $4.6 billion, respectively.

Also, on September 16, 2008, AIG was notified by its insurance regulators that it would no longer be permitted to borrow funds from its insurance company subsidiaries under a revolving credit facility that AIG had maintained with certain of its insurance subsidiaries acting as lenders. Subsequently, the insurance regulators required AIG to repay any outstanding loans under that facility and to terminate it. The intercompany facility was terminated effective September 22, 2008.

Fed Credit Agreement

By early Tuesday afternoon on September 16, 2008, it was clear that AIG had no viable private sector solution to its liquidity crisis. At this point, AIG received the terms of a secured lending agreement that the NY Fed was prepared to provide. AIG estimated that it had an immediate need for cash in excess of its available liquid resources. That night, AIG's Board of Directors approved borrowing from the NY Fed based on a term sheet that set forth the terms of the secured credit agreement and related equity participation. Over the next six days, AIG elected Edward M. Liddy, Director, Chairman, and CEO, replacing Robert Willumstad in those positions, and negotiated a definitive credit agreement with the NY Fed and borrowed, on a secured basis, approximately

$37 billion from the NY Fed before formally entering into the Fed Credit Agreement.

On September 22, 2008, AIG entered into the Fed Credit Agreement in the form of a two-year secured loan and a Guarantee and Pledge Agreement (the Pledge Agreement) with the NY Fed. See Notes 5 and 11 to the Consolidated Financial Statements for more information regarding the terms of and borrowings under the Fed Credit Agreement.

Borrowings outstanding and remaining available amount that can be borrowed under the Fed Facility were as follows:

(in millions)	Inception Through September 30, 2008	Inception Through November 5, 2008
Borrowings:		
Loans to AIGFP for collateral postings, GIA and other maturities	$35,340	$43,100
Capital contributions to insurance companies *(a)*	13,341	13,687
Repayment of obligations to securities lending program	3,160	3,160
AIG Funding commercial paper maturities	2,717	3,714
Repayment of intercompany loans	1,528	1,528
Contributions to AIGCFG subsidiaries	1,094	1,591
Debt repayments	1,038	1,578
Other borrowings *(a)*	2,782	8,642
Total borrowings	61,000	77,000
Repayments:		
Repayments not reducing available amounts	–	16,000 *(b)*
Repayments reducing available amounts	–	–
Total repayments	–	16,000
Net borrowings	61,000	61,000
Total Fed Facility	85,000	85,000
Remaining available amount	24,000	24,000
Net borrowings	61,000	61,000
Paid in kind interest and fees	1,960	1,960
Total balance outstanding	$62,960	$62,960

(a) Includes securities lending activities.
(b) Includes repayments due to funds received from the Fed Securities Lending Agreement and the CPFF.

Liquidity Related Actions and Plans

AIG's Strategy for Stabilization and Repayment of the Fed Facility

AIG has developed certain plans (described below), some of which have already been implemented, to provide stability to its businesses and to provide for the timely repayment of the Fed Facility; other plans are still being formulated.

Preferred Equity Investment by the United States Treasury Pursuant to TARP

On November 9, 2008, AIG and the United States Treasury agreed in principle to a transaction pursuant to which the United States Treasury will purchase from AIG $40 billion liquidation preference of newly issued perpetual preferred stock (Series D Preferred Shares) under TARP. The Series D Preferred Shares will be in addition to the Series C Preferred Stock that AIG is obligated to issue to the Trust in connection with the Fed Credit Agreement. AIG is required to use the net proceeds from the sale of the Series D Preferred Shares to repay a portion of the outstanding balance under the Fed Facility.

The Series D Preferred Shares will rank *pari passu* with the Series C Preferred Stock and senior to AIG's common stock. The Series D Preferred Shares will have limited class voting rights and will accumulate cumulative compounding dividends at a rate equal to 10 percent per annum. The dividends will be payable when, as and if declared by AIG's Board of Directors. AIG will not be able to declare or pay any dividends on AIG's common stock or on any AIG preferred stock ranking *pari passu* with or junior to the Series D Preferred Shares until dividends on the Series D Preferred Shares have been paid. AIG may redeem the Series D Preferred Shares at the stated liquidation preference, plus accumulated but unpaid dividends, at any time that the Trust or any successor entity beneficially owns less than 30 percent of AIG's voting securities and no holder of Series D Preferred Shares controls or has the potential to control AIG.

Pursuant to the agreement between AIG and the United States Treasury in connection with the Series D Preferred Shares, for as long as the United States Treasury owns any of the Series D Preferred Shares, AIG will be subject to restrictions on its ability to repurchase capital stock and will

be required to adopt and maintain policies on corporate expenses, lobbying activities and executive compensation.

In connection with the issuance of the Series D Preferred Shares, AIG will also issue a 10-year warrant to the United States Treasury exercisable for a number of shares of common stock of AIG equal to two percent of the issued and outstanding shares of common stock on the date of the investment. In connection with the issuance of the warrant, the voting, conversion rights and dividend rights of the Series C Preferred Stock will be reduced from 79.9 percent to 77.9 percent. The warrant will be exercisable at any time and have an exercise price equal to the par value of AIG's common stock at the time of exercise. The United States Treasury has agreed that it will not exercise any voting rights with respect to the common stock issued upon exercise of the warrant. The warrant will not be subject to contractual transfer restrictions other than restrictions necessary to comply with U.S. federal and state securities laws. AIG will be obligated, at the request of the United States Treasury, to file a registration statement with respect to the warrant and the common stock for which the warrant can be exercised. During the 10-year term of the warrant, if the shares of common stock of AIG are no longer listed or trading on a national securities exchange, AIG may be obligated, at the direction of the United States Treasury, to exchange all or a portion of the warrant for another economic interest of AIG classified as permanent equity under U.S. GAAP with an equivalent fair value. If the Series D Preferred Shares issued in connection with the warrant are redeemed in whole, AIG may repurchase the warrant then held by the United States Treasury at any time for its fair value so long as no holder of a warrant controls or has the potential to control AIG. As a result of the issuance of the warrant, the number of shares into which the Series C Preferred Stock will be convertible will be reduced so as not to exceed 77.9 percent of the outstanding shares of common stock.

The Fed Securities Lending Program

On October 8, 2008, certain of AIG's domestic life insurance subsidiaries entered into the Fed Securities Lending Agreement, providing that the NY Fed will borrow, on an overnight basis, investment grade fixed maturity securities from these AIG subsidiaries in return for cash collateral. Prior to this arrangement, draw downs under the existing Fed Facility were used, in part, to settle securities lending transactions. The NY Fed has been borrowing securities under the Fed Securities Lending Agreement, which has allowed AIG to replenish liquidity in the securities lending program on an as-needed basis, while providing possession and control of these third-party securities to the NY Fed.

As of November 5, 2008, the total value of securities lending payables was $34.2 billion, with $19.9 billion of this amount payable to the NY Fed under this agreement. This program will be terminated on the closing of the RMBS sale as described below.

Transfer of RMBS by certain AIG Insurance Subsidiaries

AIG and the NY Fed expect to establish a facility under which approximately $40 billion principal amount of residential mortgage-backed securities (RMBS) related to AIG's U.S. securities lending program will be transferred by certain AIG insurance subsidiaries to a newly-formed limited liability company (the RMBS LLC) that will be financed by the NY Fed and AIG. Proceeds to the insurance company subsidiaries, together with other AIG funds, will be used to return all cash collateral posted by securities borrowers, including approximately $19.9 billion to be returned to the NY Fed. After all collateral is returned, AIG's U.S. Securities lending program will be terminated.

The aggregate proceeds to the AIG insurance subsidiaries will be equal to the estimated fair value of the RMBS at October 31, 2008, adjusted for collections and certain other events between such date and the closing date of the purchase, which is expected to be prior to November 30, 2008. At September 30, 2008, the fair value of the RMBS being transferred was $23.5 billion. AIG will provide $1 billion of proceeds to the AIG entities and the NY Fed will provide the remainder of the proceeds up to $22.5 billion.

Interest on both the NY Fed's senior loan and AIG's subordinated loan will be capitalized (converted to principal of the related loan instead of being paid in cash). Payments of interest on, and principal of, the RMBS and the net sale proceeds, if any, on the RMBS received by the RMBS LLC will be used to pay principal of the NY Fed's senior loan in full before any payments are made on AIG's subordinated loan. None of the obligations of RMBS LLC have recourse to AIG, although AIG's subordinated loan will be exposed to losses of the RMBS LLC up to $1 billion plus the amount of capitalized interest thereon. After the loans have returned amounts equal to their principal and capitalized interest, payments with respect to the remaining RMBS received by the RMBS LLC will be allocated as contingent interest on both of the loans. There are no economic interests in the RMBS LLC other than the NY Fed's senior loan and AIG's subordinated loan.

The implementation of RMBS LLC is subject to the approval of the relevant state insurance commissioners.

Terminations of Multi-Sector Credit Default Swap Transactions

AIGFP currently has outstanding multi-sector credit default swaps with third-party counterparties related to CDOs. Such credit default swaps require that AIGFP post collateral with the counterparties to secure its obligations based on fair value deterioration, ratings downgrades of referenced obligations and downgrades of AIG's ratings. As of November 5, 2008, AIGFP had either agreed to post or posted collateral based on exposures, calculated in respect of super senior credit default swaps in an aggregate net amount of $37.3 billion.

AIG and the NY Fed expect to establish a facility in which a newly-formed limited liability company (the CDO LLC) will offer to purchase CDOs from the counterparties, who will concurrently with such purchase terminate the related credit default swaps. AIGFP and the NY Fed have begun negotiating the terminations; depending on the level of counterparty participation, on the closing date, the NY Fed will advance up to $30 billion (the Tranche A Loan) and AIG will advance up to $5 billion (the Tranche B Loan) to the CDO LLC to fund the purchase price of such CDOs. Separately, AIG will pay the costs associated with the unwind of the related credit default swaps, and so will bear the risk of declines in the market value of the CDOs through October 31, 2008. After the closing date, AIGFP will not be subject to any further collateral calls related to the terminated credit default swaps.

Interest on both the Tranche A Loan and the Tranche B Loan will be capitalized. Payments of interest on, and principal of, the CDOs received by the CDO LLC will be used to pay principal and interest of the Tranche A Loan in full before any payments are made on the Tranche B Loan. None of the obligations of the CDO LLC have recourse to AIG, although AIG's Tranche B Loan will be exposed to losses of the CDO LLC up to its principal amount plus the amount of capitalized interest thereon. After the loans have returned amounts equal to their principal and capitalized interest, payments with respect to the remaining CDOs received by the CDO LLC will be allocated as contingent interest on both of the loans. There are no economic interests in the CDO LLC other than the Tranche A Loan and Tranche B Loan.

Because the successful implementation of the proposed establishment of the CDO LLC depends on the agreement of the counterparties to terminate their super senior credit default swaps, no assurance can be given that this facility will be completed or, if completed, on the level of participation.

Commercial Paper Funding Facility

On October 27, 2008, four AIG affiliates applied for participation in the NY Fed's Commercial Paper Funding Facility (CPFF). AIG Funding, Inc., ILFC, Curzon Funding LLC and Nightingale Finance LLC may issue up to approximately $6.9 billion, $5.7 billion, $7.2 billion and $1.1 billion, respectively, of commercial paper under the CPFF. As of November 5, 2008, these entities had borrowed a total of approximately $15.2 billion under this facility, which allowed AIG to repay borrowings under the Fed Facility.

These AIG affiliates are participating in the CPFF on the same terms and conditions as other non-AIG companies.

Proceeds from the issuance of the commercial paper will be used to refinance AIG's outstanding commercial paper as it matures, meet other working capital needs and make voluntary prepayments under the Fed Facility. The voluntary repayments of the Fed Facility will not reduce the amount available to be borrowed thereunder.

Asset Disposition Plan

AIG has recently hired a Vice Chairman and Chief Restructuring Officer to oversee the asset disposition plan and has developed a plan to sell assets and businesses to repay the Fed Facility.

AIG intends to retain the majority of its U.S. property and casualty and foreign general insurance businesses, and to retain an ownership interest in certain of its foreign life insurance operations. AIG is exploring divestiture opportunities for its remaining businesses. Proceeds from these sales are contractually required to be applied toward the repayment of the Fed Facility. None of the businesses under consideration for sale at September 30, 2008 met the criteria in Statement of Financial Accounting Standards (FAS) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" to qualify as "held for sale." AIG continues to evaluate the status of its asset sales with respect to these criteria.

In connection with AIG's asset disposition plan, subsequent to September 30, 2008, AIG entered into negotiations to sell certain operations in its General Insurance, Life Insurance and Retirement Services, Financial Services and Asset Management operating segments. These operations had total assets and liabilities with carrying values of approximately $9 billion and $6 billion, respectively, at September 30, 2008. AIG expects to enter into purchase agreements with respect to these assets during the fourth quarter of 2008.

Dispositions of certain businesses may be subject to regulatory approval.

Expense Reductions and Preservation of Cash and Capital

AIG has named a Vice Chairman, Transition Planning and Chief Administrative Officer to lead expense reduction initiatives and transition planning. AIG has developed a plan to review significant projects and will eliminate, delay, or curtail those that are discretionary or non-essential and to make available internal resources, reduce cash outflows to outside service providers to improve liquidity. AIG also suspended the dividend on its common stock to preserve capital.

Negative Effects of Liquidity Events

As a result of AIG's deteriorated financial condition and its announced strategies, AIG's businesses have been subjected to strained relationships with customers, brokers, agents, other business partners and employees as well as increased monitoring

by regulatory agencies. Specific issues related to AIG's businesses are addressed below.

General Insurance

While the Commercial Insurance Group (CIG) has been generally successful in retaining clients, the amount of business AIG underwrites for clients has declined. Concern over AIG's

financial strength has a particularly adverse effect on CIG underwriting of directors' and officers' insurance, especially at the higher attachment points.

New business activity has been at lower levels, and AIG continues to see pricing pressure in its general insurance business.

The domestic property and casualty companies are beneficiaries of $5.7 billion of letters of credit arranged by AIG and its subsidiaries. Letters of credit totaling $4.2 billion will expire on December 31, 2008 and the remainder will expire on December 31, 2010. These letters of credit secure amounts recoverable from both affiliated and unaffiliated reinsurers. The inability of AIG to renew or replace these letters of credit or otherwise obtain equivalent financial support from AIG or a third-party would result in a significant reduction of the statutory surplus of these property and casualty insurance companies. AIG is pursuing alternatives to letters of credit such as trust agreements and other forms of credit support and is also pursuing opportunities to significantly reduce the need for such security after December 31, 2008.

Capital Maintenance

AIG has capital maintenance agreements with the companies included in the Commercial Insurance and Mortgage Guaranty reporting units under which AIG may be required to provide ongoing capital support.

Life Insurance & Retirement Services

Disruptions in markets throughout the world and AIG's recent liquidity issues have had, and AIG expects will continue to have, a significant adverse effect on Life Insurance & Retirement Services operating results, specifically its net investment income, deferred policy acquisition costs (DAC) and sales inducement asset (SIA) amortization and net realized capital losses in 2008. AIG expects that these events and AIG's previously announced asset disposition plan will continue to be key factors in the remainder of 2008 and into 2009. In addition, AIG parent's liquidity issues have affected certain operations through higher surrender activity, particularly in the U.S. domestic retirement service's fixed annuity business and foreign investment-oriented and retirement service's products in Japan and Asia. For Japan and Korea, surrenders are expected to continue to be higher than historic averages in the next quarter and possibly beyond due to the suspension of sales by some banks, equity market volatility and elevated levels of surrenders. While surrender levels have declined from their peaks in mid-September, they are still higher than historic levels and AIG expects them to remain at these higher than historic levels until the uncertainties relating to AIG are resolved.

These uncertainties, together with rating agency downgrades, have resulted in reduced levels of new sales activity, particularly among products and markets where ratings are critical. Sales of investment-oriented and retirement services products in Japan and Asia have also declined. New sales activity is expected to remain at lower levels until the uncertainties relating to AIG are resolved.

Due to the high volume of surrender activity for certain investment-oriented products in the U.K., surrender payments were temporarily suspended in accordance with contract terms to provide time to develop an appropriate course of action with the respective distribution network and to protect the interests of the fund's policyholders.

During the three months ended September 30, 2008 and through October 29, 2008, AIG contributed capital totaling $16.6 billion ($11.8 billion of which was contributed using borrowings under the Fed Facility) to certain of its Domestic Life Insurance and Domestic Retirement Services subsidiaries to replace a portion of the capital lost as a result of net realized capital losses. Further capital contributions will be required to the extent additional net realized capital losses are incurred. In Taiwan, AIG expects to contribute approximately $1.4 billion to Nan Shan in November 2008 as a result of the continued declines in the Taiwan equity market. AIG made capital contributions of $1.3 billion to support foreign life operations in Hong Kong and Japan, principally due to the steep decline in AIG's common stock price. Additional capital contributions to certain operations may be necessary during the remainder of 2008, in large measure due to the continued effect of equity market volatility, declining bond prices and net realized capital losses resulting from other-than-temporary impairment charges.

Financial Services

International Lease Finance Corporation

As a result of AIG parent's liquidity issues and related credit rating downgrades, ILFC was unable to borrow in the public short-term and long-term debt markets, and therefore, ILFC borrowed $6.5 billion under its credit facilities in September 2008. ILFC expects to use these borrowings to repay maturing commercial paper and other obligations. AIG expects that ILFC may raise additional funds through secured lending transactions in early 2009. ILFC can also issue commercial paper under the CPFF. ILFC believes that these borrowings and cash from operations, which may include aircraft sales, will permit ILFC to meet its obligations through September 2009, after which AIG would rely upon additional asset sales and funding through the Fed Facility.

Capital Markets

Given the extreme market conditions during the third quarter of 2008, downgrades of AIG's credit ratings by the rating

agencies, as well as AIG's intention to refocus on its core business, AIGFP began unwinding certain of its businesses and portfolios. AIG is only entering into new derivative transactions to maintain its current portfolio, reduce risk and hedge

the currency and interest rate risks associated with its affiliated businesses. AIG is also opportunistically terminating contracts. Due to the long-term duration of AIGFP's derivative contracts and the complexity of AIGFP's portfolio, AIG expects that an orderly wind-down will take a substantial period of time.

American General Finance

As a result of AIG parent's liquidity issues and the related credit ratings downgrades, AGF suspended its efforts to borrow in the public short-term and long-term debt markets. As a result, AGF borrowed approximately $4.6 billion under its primary credit facilities in September 2008. AGF anticipates that its primary sources of funds to support its operations and repay its obligations will be finance receivable collections from operations and secured financings, which will require it to limit its lending activities and focus on expense savings. AGF anticipates that its existing sources of funds will be sufficient to meet its debt and other obligations through the first quarter of 2009. AGF will need additional sources of funds at that time, including sales of AGF assets and funding through the Fed Facility.

AIG Consumer Finance Group

AIG's recent liquidity issues and related credit ratings downgrades have materially adversely affected AIG Consumer Finance Group, Inc. (AIGCFG). AIGCFG experienced significant deposit withdrawals in Hong Kong during September 2008. The inability of AIGCFG to access its traditional sources of funding resulted in AIG lending $1.6 billion to subsidiaries of AIGCFG in September and October of 2008. AIG expects that these businesses will continue to be materially adversely affected until the current uncertainties concerning AIG and the potential sale of these businesses are resolved.

Asset Management

The principal cash requirements in Asset Management are to fund warehousing activities, existing capital commitments and certain direct investments.

General disruption in the global equity and credit markets and the liquidity issues at AIG have negatively affected the Institutional Asset Management segment operating results. Distressed global markets have reduced the value of assets under management, translating to lower base management fees and reduced performance fees (carried interest). Tight credit markets have put pressure on the commercial and residential real estate markets, which has caused values in certain geographic locations to fall, resulting in impairment charges on real estate held for investment purposes.

AIG parent's liquidity issues and lower asset performance as a result of challenging market conditions have contributed to the loss of institutional and retail clients as well as higher redemptions from some of AIG's managed hedge and mutual funds. The continued uncertainty in the equity and credit markets, as well as AIG parent's liquidity issues and the proposed asset dispositions, will continue to adversely affect management and performance fees as well as AIG's ability to launch new funds and investment strategies.

Within the Spread-Based Investment business, distressed markets have resulted in significant loss of invested asset value and AIG expects such losses to continue through the remainder of 2008. In addition, given market conditions, AIG does not expect to issue any additional debt to fund the MIP for the foreseeable future.

Other Effects

As disclosed in its 2007 Annual Report on Form 10-K, AIG expected to contribute approximately $118 million to its U.S. and non-U.S. pension plans in 2008. For the nine months ended September 30, 2008, AIG had contributed $122 million to its U.S. and non-U.S. pension plans. Based upon the current funded status of the plans, the current interest rate environment, and the projected performance of pension plan assets, additional expected contributions for the U.S. and non-U.S. pension plans in the 2008 fourth quarter range from approximately $168 million to $532 million. Actual contributions, however, will depend on asset performance, foreign exchange rates, and the interest rate environment as of December 31, 2008. Actual contributions may also vary as a result of anticipated dispositions.

Regulators in various jurisdictions in which AIG entities operate have imposed additional requirements on the AIG entities. These requirements primarily require AIG to obtain prior approval from the regulator for transactions related to the dispositions of assets, transfers of cash or other transactions outside the normal course of business. In addition, certain regulators have requested additional capital or collateral to be posted. To date, these requirements have not had a significant effect on AIG's operations.

AIG conducted an annual goodwill impairment review as of June 30, 2008. In connection with the decline in the price of AIG's common stock during the third quarter of 2008, AIG conducted an updated goodwill impairment test as of September 30, 2008. As a result of the updated test AIG recognized goodwill impairment charges of $432 million for the three-month period ended September 30, 2008, which were primarily related to the domestic Consumer Finance and the Capital Markets businesses.

In addition, the excess of the fair value over the carrying value of AIG's Personal Lines and foreign Consumer Finance

businesses narrowed subsequent to the June 30, 2008 test. As of September 30, 2008, goodwill related to these businesses totaled approximately $700 million and $344 million, respectively. A continuation of the decline in fair value of these

TAB C - American International Group, Inc. (AIG) Materials

businesses could result in impairment of goodwill in the future.

Risk Factors

The following supplements the significant factors that may affect AIG's business and operations described under "Risk Factors" in Item 1A. of Part I of AIG's 2007 Annual Report on Form 10-K.

Business and Credit Environment

AIG's businesses, results of operations and financial condition have been materially and adversely affected by recent market conditions.

During the third quarter of 2008 continuing through November 2008, worldwide economic conditions significantly deteriorated. The decline in economic conditions has resulted in highly volatile markets, a steep decline in equity markets, further and continuing lack of liquidity, a widening of credit spreads, a lack of price transparency and the collapse of several prominent financial institutions. Global regulators and central banks have taken a number of unprecedented steps to address these issues, but it is unclear whether these measures will be effective or, if effective, when the markets will stabilize.

AIG has been materially and adversely affected by these conditions and events in a number of ways, including:

- severe and continued declines in its investment portfolio, leading to significant other-than-temporary impairments;
- significant credit losses due to the failure of, or governmental intervention with respect to, several prominent institutions; and
- a general decline in business activity.

The consequences of these conditions have been more severe for AIG than for other insurers. AIG expects its businesses, financial condition and results of operations will continue to be materially and adversely affected by these conditions for the foreseeable future.

AIG is subject to extensive litigation that may have a material adverse effect on its consolidated financial condition or its consolidated results of operations.

As described in Note 7(a) to the Consolidated Financial Statements, AIG is subject to extensive litigation, including securities class actions. Due to the nature of this litigation, the lack of precise damage claims and the type of claims made against AIG, AIG cannot currently quantify its ultimate liability for these actions. It is possible that such liability could have a material adverse effect on AIG's consolidated financial condition or consolidated results of operations for an individual reporting period.

Credit and Financial Strength Ratings

Adverse ratings actions regarding AIG's long-term debt ratings by Moody's or S&P would require AIG to make additional substantial collateral payments under existing derivative transactions to which AIGFP is a party, which could adversely affect AIG's business and its consolidated results of operations and financial condition.

On September 15, 2008, the following credit rating actions were taken:

- Standard & Poor's, a division of The McGraw-Hill Companies, Inc. (S&P), lowered its long-term debt rating on AIG to 'A-' from 'AA-', and its short-term debt rating to 'A-2' from 'A-1+'. S&P also downgraded the long-term debt and short-term debt ratings of International Lease Finance Corp. (ILFC) to 'A-' from 'A+' and to 'A-2' from 'A-1,' respectively and the long-term and short-term debt ratings of American General Finance Corporation (AGF Corp.) to 'BBB' from 'A+' and to 'A-3' from 'A-1,' respectively. At the same time, S&P lowered its counterparty credit and financial strength ratings on most of AIG's insurance operating subsidiaries to 'A+' from 'AA+'. All of the ratings remained on CreditWatch Negative.
- Moody's Investors Service (Moody's) lowered AIG's senior unsecured debt ratings to 'A2' from 'Aa3' and placed the long-term and short-term ratings on review for possible downgrade. In addition, Moody's downgraded the ratings of several AIG subsidiaries, including the Domestic Life Insurance and Retirement Services companies (Insurer Financial Strength Rating to 'Aa3' from 'Aa2'), and ILFC and AGF Corp. (Senior Unsecured Debt Rating to 'A3' from 'A1' and short-term debt rating to 'P-2' from 'P-1.') Nearly all of AIG's subsidiaries remained on review for possible downgrade.
- Fitch Ratings (Fitch) lowered AIG's long-term issuer rating to 'A' from 'AA-' and its short-term issuer rating to 'F1' from 'F1+'. In addition, Fitch downgraded nearly all of AIG's subsidiaries' Insurer Financial Strength Ratings to 'AA-' from 'AA+.' A majority of the ratings remained on Rating Watch Negative.
- A.M. Best Company (A.M. Best) lowered AIG's issuer credit rating to 'bbb' from 'a+'. In addition, A.M. Best downgraded most of AIG's Insurer Financial Strength Ratings to 'A' from 'A+' and placed the ratings under review with negative implications.

As a consequence of the rating actions, AIGFP estimated that it would need in excess of $20 billion in order to fund additional collateral demands and transaction termination payments in a short period of time. Subsequently, in a period of approximately 15 days following the rating actions, AIGFP was required to fund approximately $32 billion, reflecting not only the effect of the rating actions but also changes in market levels and other factors.

Following the agreement with the NY Fed announced on September 17, 2008, the following credit rating actions were taken:

- S&P upgraded AIG's and ILFC's short-term debt ratings to 'A-1' from 'A-2' and revised the CreditWatch status on all ratings from CreditWatch Negative to CreditWatch Developing.
- Fitch revised the rating watch status on all ratings from Rating Watch Negative to Rating Watch Evolving.

Following AIG's strategic review press release on October 3, 2008, the following credit rating actions were taken:

- S&P revised the CreditWatch status on AIG's and AGF Corp.'s ratings from CreditWatch Developing to CreditWatch Negative.
- Moody's downgraded AIG's Senior Unsecured Debt rating to 'A3' from 'A2' and ILFC and AGF Corp.'s Senior Unsecured Debt ratings to 'Baa1' from 'A3.' Most ratings remain under review for possible downgrade with ILFC revised to under review with direction uncertain.

Credit ratings measure a company's ability to repay its obligations and directly affect the cost and availability to that company of unsecured financing.

In the event of a further downgrade of AIG's long-term senior debt ratings, AIG would be required to post additional collateral and AIG or its counterparties would be permitted to elect early termination of contracts.

It is estimated that as of the close of business on October 27, 2008, based on AIGFP's outstanding municipal GIAs and financial derivative transactions at that date, a downgrade of AIG's long-term senior debt ratings to Baa1 by Moody's and BBB+ by S&P would permit counterparties to make additional calls and permit either AIG or the counterparties to elect early termination of contracts, resulting in up to approximately $5.2 billion of collateral and termination payments, while a downgrade to Baa2 by Moody's and BBB by S&P would result in approximately $0.3 billion in additional collateral and termination payments.

For the multi-sector super senior credit default swap portfolio, it is estimated based on the October 24, 2008 notional values a downgrade of AIG's long-term senior debt ratings to Baa1 by Moody's and BBB+ by S&P, would increase the amount of collateral posted by approximately $2.7 billion due to the adjustment of threshold and independent amount percentages. A downgrade to Baa2 by Moody's and BBB by S&P would allow the counterparties to certain 2a7 puts to elect early termination, resulting in a cash outflow of approximately $3.7 billion. In addition, at that rating level, counterparties to transactions representing approximately $47.8 billion in net notional amount have the right to elect early termination. In the event a counterparty elects to terminate a transaction early, such transaction will be terminated at its replacement value, less any previously posted collateral. Due to current market conditions, it is not possible to reliably estimate the replacement cost of these transactions.

The actual amount of collateral that AIGFP would be required to post to counterparties in the event of such downgrades, or the aggregate amount of payments that AIG could be required to make, depends on market conditions, the fair value of outstanding affected transactions and other factors prevailing at the time of the downgrade. Additional obligations to post collateral or the costs of assignment, repayment or alternative credit could exceed the amounts available under the Fed Credit Agreement. See discussion of the Fed Credit Agreement below.

A downgrade in the short-term credit ratings of the commercial paper programs of certain AIG affiliates could make these issuers ineligible for participation in the NY Fed's Commercial Paper Funding Facility (CPFF).

AIG's affiliates AIG Funding, Inc., ILFC, Curzon Funding LLC and Nightingale Finance LLC currently participate in the CPFF. However, in the event of a downgrade of the short-term credit ratings applicable to the commercial paper programs of these issuers, the affiliates may no longer qualify for participation in the CPFF. The CPFF only purchases U.S. dollar-denominated commercial paper (including asset-backed commercial paper) that is rated at least A-1/P-1/F1 by a major nationally recognized statistical rating organization (NRSRO) or, if rated by multiple major NRSROs, is rated at least A-1/P-1/F1 by two or more major NRSROs. Accordingly, these AIG affiliates will lose access to the CPFF if:

- AIG Funding's short-term rating is downgraded by any two of S&P, Moody's or Fitch;
- ILFC's short-term rating is downgraded by either S&P or Fitch;
- Curzon Funding LLC's short-term rating is downgraded by either S&P or Moody's; and
- Nightingale Finance LLC's short-term rating is downgraded two notches by S&P or one notch by Moody's.

A downgrade in the Insurer Financial Strength ratings of AIG's insurance companies could prevent the companies from writing new business and retaining customers and existing business.

Financial strength ratings by the major ratings agencies are an important factor in establishing the competitive position of insurance companies. Financial strength ratings measure an insurance company's ability to meet its obligations to contract

holders and policyholders, help maintain public confidence in a company's products, facilitate marketing of products and enhance a company's competitive position.

Further downgrades of the Insurer Financial Strength ratings of AIG's insurance companies may prevent these

companies from offering products and services or result in increased policy cancellations or termination of assumed reinsurance contracts. Moreover, a downgrade in AIG's credit ratings may, under credit rating agency policies concerning the relationship between a parent's and subsidiary's ratings, result in a downgrade of the Insurer Financial Strength ratings of AIG's insurance subsidiaries.

Fed Facility

The Fed Credit Agreement and the Series D Preferred Shares will require AIG to devote significant resources to debt repayment and preferred dividends for the foreseeable future, thereby reducing capital available for other purposes.

AIG is required to repay the Fed Credit Agreement primarily from the proceeds of sales of assets, including businesses. These mandatory repayments permanently reduce the amount available under the Fed Credit Agreement.

In addition, American General Finance, Inc. (AGF) and ILFC have drawn the full amounts available under their revolving credit facilities and currently do not have access to their traditional sources of long-term or short-term financing through the public debt markets.

Unanticipated collateral calls, continued high surrenders, a downgrade in AIG's credit ratings or a further deterioration in AIGFP's super senior credit default swap portfolio may cause AIG to need additional funding in excess of the borrowings available under the Fed Credit Agreement. If AIG needs funds in excess of those available under the Fed Credit Agreement, AIG will need to find additional financing. Further, an inability to effect asset sales in accordance with its asset disposition plan may result in AIG not being able to timely repay its borrowings under the Fed Credit Agreement. See also Significant Liquidity Requirements — Asset Disposition Plan for a discussion of AIG's asset disposition plan.

The Series D Preferred Shares pay a 10 percent dividend which will not be deductible for tax purposes.

AIG's substantial obligations will require it to dedicate all of its proceeds from asset sales and a considerable portion of its cash flows from operations to the repayment of the Fed Facility, thereby reducing the funds available for other purposes. In addition, because AIG's debt service and preferred dividend obligations will be very high, AIG may be more vulnerable to competitive pressures and expects to have less flexibility to plan for or respond to changing business and economic conditions.

Borrowings under the Fed Credit Agreement are subject to the NY Fed being satisfied with the collateral pledged by AIG.

A condition to borrowing under the Fed Credit Agreement is that the NY Fed be satisfied with the collateral pledged by AIG (including its value). It is possible that the NY Fed may determine that AIG's collateral is insufficient to permit a borrowing for many reasons including:

- a decline in the value of AIG's businesses;
- poor performance in one or more of AIG's businesses; and
- low prices received by AIG in its asset disposition plan.

Such a determination could limit AIG's ability to borrow under the Fed Facility.

AIG must sell significant assets to service the debt under the Fed Credit Agreement.

AIG must make asset sales to repay the borrowings under the Fed Credit Agreement. A delay or inability to effect these sales at acceptable prices and terms could result in AIG being unable to repay the Fed Credit Agreement by its maturity date.

While AIG has adopted an asset disposition plan, as discussed under Significant Liquidity Requirements, this plan may not be successfully executed due to, among other things:

- an inability of purchasers to obtain funding due to the deterioration in the credit market;
- a general unwillingness of potential buyers to commit capital in the difficult current market environment; and
- an adverse change in interest rates and borrowing costs.

Further, due to AIG's need to dispose of assets, AIG may be unable to negotiate favorable terms.

If AIG is not able to execute its disposition plan, and cannot otherwise repay the Fed Facility in accordance with its terms, an event of default would result. If an event of default were to occur, the NY Fed could, among other things, declare outstanding borrowings under the Fed Facility immediately due and payable. In addition, an event of default or declaration of acceleration under the Fed Credit Agreement could also result in an event of default under other agreements.

The Fed Credit Agreement includes financial and other covenants that impose restrictions on AIG's financial and business operations.

The Fed Credit Agreement requires AIG to maintain a minimum aggregate liquidity level and restricts AIG's ability to make certain capital expenditures if the NY Fed objects thereto. In addition, the Fed Credit Agreement restricts AIG's and its restricted subsidiaries' ability to incur additional indebtedness, incur liens, merge, consolidate, sell assets, enter into hedging transactions outside the normal course of business, or pay dividends. These covenants could restrict AIG's business and thereby adversely affect AIG's results of operations.

Moreover, if AIG fails to comply with the covenants in the Fed Credit Agreement and is unable to obtain a waiver or amendment, an event of default would result. If an event of default were to occur, the NY Fed could, among other things, declare outstanding borrowings under the Fed Credit Agreement immediately due and payable. In addition, an event of default or declaration of acceleration under the Fed Credit Agreement could also result in an event of default under other agreements.

AIG's results of operations will be materially adversely affected by a significant increase in interest expense.

AIG expects its results of operations in the fourth quarter of 2008 and in 2009 to be significantly adversely affected by the recognition of interest expense. AIG's initial $1.7 billion commitment fee will amortize over the term of the Fed Facility. Finally, the prepaid commitment fee asset of $23 billion associated with the Preferred Stock to be issued will be amortized through interest expense over the term of the Fed Facility. As a result, AIG anticipates that interest expense in the fourth quarter of 2008 and in the year ended December 31, 2009 will significantly increase as a result of these items. In addition, paid in kind interest expense under the Fed Facility is accrued over the term of the Fed Facility.

Liquidity

AIG's businesses have been adversely affected by AIG's reduced liquidity.

Many of AIG's businesses depend upon the financial stability (both actual and perceived) of AIG parent. Perceptions that AIG or its subsidiaries may not be able to meet their obligations can negatively affect AIG's businesses in many ways, including:

- requests by customers to withdraw funds from AIG under annuity and certain life insurance contracts;
- a refusal by independent agents, brokers and banks to continue to offer AIG products and services;
- a refusal of customers or vendors to continue to do business with AIG; and
- requests by customers and other parties to terminate existing contractual relationships.

AIG's ability to access funds from its subsidiaries is limited.

As a holding company, AIG depends on dividends, distributions and other payments from its subsidiaries to fund payments on AIG's obligations, including its debt securities. In light of AIG's current financial situation, AIG expects that its regulated subsidiaries may be significantly restricted from making dividend payments, or advancing funds, to AIG. This restriction may hinder AIG's ability to access funds that AIG may need to make payments on its obligations, including those arising from day-to-day business activities.

Controlling Shareholder

As a result of the issuance of the Series C Preferred Stock, AIG will be controlled by a trust holding the Series C Preferred Stock for the benefit of the United States Treasury. AIG's interests and those of AIG's minority shareholders may not be the same as those of the United States Treasury.

In accordance with the Fed Credit Agreement, AIG will issue 100,000 shares of Series C Perpetual, Convertible, Participating Preferred Stock (the Series C Preferred Stock) to a trust that will hold the Series C Preferred Stock for the benefit of the United States Treasury (the Trust). Pursuant to the agreement in principle reached by AIG and the NY Fed on November 9, 2008 to amend the NY Fed Credit Agreement, the Series C Preferred Stock is entitled to:

- participate in any dividends paid on the common stock, with the payments attributable to the Series C Preferred Stock being approximately, but not in excess of, 77.9 percent of the aggregate dividends paid on AIG's common stock, treating the Series C Preferred Stock as converted; and
- to the extent permitted by law, vote with AIG's common stock on all matters submitted to AIG's shareholders and hold approximately, but not in excess of, 77.9 percent of the aggregate voting power of the common stock, treating the Series C Preferred Stock as converted.

The Series C Preferred Stock will remain outstanding even if the Fed Facility is repaid in full or otherwise terminates. In addition, upon shareholder approval to certain amendments to AIG's certificate of incorporation, the Trust can convert the Series C Preferred Stock into AIG common stock.

As a result of its ownership, the Trust will be able to elect all of AIG's directors and can control the vote on all matters, including:

- approval of mergers or other business combinations;
- a sale of all or substantially all of AIG's assets;
- issuance of any additional common stock or other equity securities;
- the selection and tenure of AIG's Chief Executive Officer and other executive officers;

- the adoption of amendments to AIG's certificate of incorporation; and
- other matters that might be favorable to the United States Treasury.

Moreover, the Trust's ability to prevent an unsolicited bid for AIG or any other change in control could also have an adverse effect on the market price of AIG's common stock.

The Trust may also transfer the Series C Preferred Stock to another person or entity and that person or entity may become AIG's controlling shareholder.

Possible future sales of Series C Preferred Stock or AIG common stock by the Trust could adversely affect the market for AIG common stock.

AIG has agreed to file a shelf registration statement that will allow the Trust to sell Series C Preferred Stock or any shares of common stock it receives upon conversion of the Preferred Stock. In addition, the Trust could sell Series C Preferred Stock or shares of AIG common stock without registration under certain circumstances, such as in a private transaction. Although AIG can make no prediction as to the effect, if any, that such sales would have on the market price of AIG common stock, sales of substantial amounts of Series C Preferred Stock or AIG common stock, or the perception that such sales could occur, could adversely affect the market price of AIG common stock. If the Trust sells or transfers shares of Series C Preferred Stock or AIG common stock as a block, another person or entity could become AIG's controlling shareholder.

Employees

The decline in AIG's common stock price and the announcement of proposed asset dispositions may prevent AIG from retaining key personnel.

AIG relies upon the knowledge and talent of its employees to successfully conduct business. The decline in AIG's common stock price has dramatically reduced the value of equity awards previously granted to its key employees. In addition, the announcement of proposed asset dispositions may result in competitors seeking to hire AIG's key employees. AIG has implemented retention programs to seek to keep its key employees, but there can be no assurance that the programs will be effective. A loss of key personnel could reduce the value of AIG's businesses and impair its ability to effect a successful asset disposition plan.

Change of Control

The issuance of the Series C Preferred Stock may have adverse regulatory consequences for AIG and its subsidiaries and may trigger contractual obligations to third parties.

The Trust will control AIG by virtue of its ownership of the Series C Preferred Stock. AIG and its subsidiaries are subject to various regulatory requirements and are a party to various contracts, agreements, licenses, permits, authorizations and other arrangements (collectively, Arrangements) that contain provisions that, upon a change of control, provide regulators and counterparties with rights to take actions that could have a material effect on AIG's consolidated financial condition, results of operations, or cash flows from an operational, regulatory, compliance, or economic standpoint.

AIG has initiated discussions and activities with regulators and counterparties to take necessary actions to remedy, amend, or comply with the provisions of these Arrangements. AIG has not been notified by regulators or counterparties of their intent to exercise their rights under the Arrangements to a material extent. However, AIG cannot presently predict the effects, if any, the change of control or the other recent events will have on the Arrangements or on AIG's consolidated financial condition, results of operations, or cash flows.

Results of Operations

AIG identifies its operating segments by product line, consistent with its management structure. These segments are General Insurance, Life Insurance & Retirement Services, Financial Services and Asset Management. Through these operating segments, AIG provides insurance, financial and investment products and services to both businesses and individuals in more than 130 countries and jurisdictions. AIG's Other category consists of items not allocated to AIG's operating segments.

AIG's subsidiaries serve commercial, institutional and individual customers through an extensive property-casualty and life insurance and retirement services network. AIG's Financial Services businesses include commercial aircraft and equipment leasing, capital markets operations and consumer finance, both in the United States and abroad. AIG also provides asset management services to institutions and individuals.

Consolidated Results

AIG's consolidated statements of income (loss) were as follows:

(in millions)	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Percentage Increase/ (Decrease)	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Percentage Increase/ (Decrease)
Revenues:						
Premiums and other considerations	**$ 21,082**	$19,733	7%	**$ 63,489**	$58,908	8%
Net investment income	**2,946**	6,172	(52)	**14,628**	21,149	(31)
Net realized capital losses	**(18,312)**	(864)	–	**(30,482)**	(962)	–
Unrealized market valuation losses on AIGFP super senior credit default swap portfolio	**(7,054)**	(352)	–	**(21,726)**	(352)	–
Other income	**2,236**	5,147	(57)	**8,953**	12,888	(31)
Total revenues	**898**	29,836	(97)	**34,862**	91,631	(62)
Benefits and expenses:						
Incurred policy losses and benefits	**17,189**	15,595	10	**51,521**	47,962	7
Policy acquisition and other insurance expenses	**6,919**	5,357	29	**18,560**	15,508	20
Interest expense	**2,297**	1,232	86	**4,902**	3,425	43
Other expenses	**2,678**	2,773	(3)	**8,084**	7,357	10
Total benefits and expenses	**29,083**	24,957	17	**83,067**	74,252	12
Income (loss) before income taxes (benefits) and minority interest	**(28,185)**	4,879	–	**(48,205)**	17,379	–
Income taxes (benefits)	**(3,480)**	1,463	–	**(10,374)**	4,868	–
Income (loss) before minority interest	**(24,705)**	3,416	–	**(37,831)**	12,511	–
Minority interest	**237**	(331)	–	**201**	(1,019)	–
Net income (loss)	**$(24,468)**	$ 3,085	–%	**$(37,630)**	$11,492	–%

Premiums and Other Considerations

Premiums and other considerations increased in the three-month period ended September 30, 2008 compared to the same period in 2007 primarily due to increases of $854 million, $420 million and $219 million in premiums from Foreign Life Insurance & Retirement Services, Foreign General Insurance, and Domestic Life Insurance, respectively, partially offset by a decrease of $207 million in premiums from Commercial Insurance. Premiums and other considerations increased in the nine-month period ended September 30, 2008 compared to the same period in 2007 primarily due to increases of $2.9 billion, $1.7 billion, and $513 million in premiums from Foreign Life Insurance & Retirement Services, Foreign General Insurance, and Domestic Life Insurance, respectively, partially offset by a decrease of $855 million in premiums from Commercial Insurance. Foreign Life Insurance & Retirement Services premiums increased principally as a result of increased production and favorable foreign exchange rates. Foreign General Insurance premiums increased primarily due to the positive effect of changes in foreign currency exchange rates and new business from both established and new distribution channels. Domestic Life Insurance premium increased primarily due to an increase in sales of payout annuities. Commercial Insurance premiums decreased primarily due to declines in workers' compensation premiums and other casualty lines of business.

Net Investment Income

The components of consolidated net investment income were as follows:

(in millions)	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Percentage Increase/ (Decrease)	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Percentage Increase/ (Decrease)
Fixed maturities, including short-term investments	**$ 5,773**	$5,406	7%	**$16,691**	$15,976	4%
Equity securities	**277**	226	23	**496**	443	12
Interest on mortgage and other loans	**407**	371	10	**1,182**	1,056	12
Partnerships	**(813)**	274	–	**(641)**	1,444	–
Mutual funds	**(632)**	(19)	–	**(656)**	430	–
Trading account losses	**(501)**	(79)	–	**(722)**	(93)	–
Other investments	**228**	107	113	**768**	665	15
Total investment income before policyholder income and trading gains (losses)	**4,739**	6,286	(25)	**17,118**	19,921	(14)
Policyholder investment income and trading gains (losses)	**(1,561)**	149	–	**(1,729)**	2,026	–
Total investment income	**3,178**	6,435	(51)	**15,389**	21,947	(30)
Investment expenses	**232**	263	(12)	**761**	798	(5)
Net investment income	**$ 2,946**	$6,172	(52)%	**$14,628**	$21,149	(31)%

Net investment income decreased in the three- and nine-month periods ended September 30, 2008 compared to the same periods in 2007 due to losses from partnerships, hedge funds and mutual funds as well as policyholder trading losses and higher trading account losses related to certain investment-oriented products in the U.K. for Life Insurance & Retirement Services. Policyholder trading gains (losses) are offset by a charge or benefit to incurred policy losses and benefits expense. The policyholder trading losses for the three- and nine-month periods ended September 30, 2008 generally reflect the trends in equity markets, principally in Japan and Asia. The decline in net investment income also reflects the effects of higher cash balances for liquidity purposes.

Net Realized Capital Losses

The composition of net realized capital losses was as follows:

(in millions)	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Sales of fixed maturity securities	**$ (768)**	$(403)	**$ (778)**	$(572)
Sales of equity securities	**288**	265	**608**	708
Sales of real estate and other assets	**97**	210	**422**	709
Other-than-temporary impairments:				
Severity	**(7,327)**	–	**(16,275)**	–
Lack of intent to hold to recovery	**(8,299)**	(240)	**(9,320)**	(614)
Trading at 25 percent or more discount for nine consecutive months	**–**	–	**–**	(6)
Foreign currency declines	**(50)**	(29)	**(1,084)**	(333)
Issuer-specific credit events	**(3,453)**	(124)	**(3,946)**	(316)
Adverse projected cash flows on structured securities	**(747)**	(151)	**(1,621)**	(159)
Foreign exchange transactions	**1,996**	(361)	**1,258**	(469)
Derivative instruments	**(49)**	(31)	**254**	90
Total	**$(18,312)**	$(864)	**$(30,482)**	$(962)

Net realized capital losses increased in the three- and nine-months ended September 30, 2008 compared to the same periods in 2007 primarily due to an increase in other-than-temporary impairment charges. Other-than-temporary impairment charges included the change in AIG's intent and ability to hold to recovery the securities, held as collateral in the securities lending program; an increase in severity losses primarily related to certain RMBS, other structured securities and securities of financial institutions due to rapid and severe market valuation declines where the impairment period was not deemed temporary; and issuer specific credit events; partially offset by the favorable effect of foreign exchange transactions due to

strengthening of the U.S. dollar. See Invested Assets — Portfolio Review — Other-Than-Temporary Impairments.

Unrealized Market Valuation Losses on AIGFP Super Senior Credit Default Swap Portfolio

The unrealized market valuation losses on AIGFP's super senior credit default swap portfolio in the three- and nine- month periods ended September 30, 2008 increased compared to the same periods in 2007 due to significant widening in credit spreads and the downgrades of RMBS and CDO securities by rating agencies in the three-month period ended September 30, 2008 driven by the credit concerns resulting from U.S. residential mortgages and the severe liquidity crisis affecting the markets. (See Capital Markets Results and Critical Accounting Estimates — Valuation of Level 3 Assets and Liabilities.

Other Income

Other Income decreased in the three-month period ended September 30, 2008 compared to the same period in 2007 primarily due to a $2.0 billion decrease in Financial Services revenues and a $625 million decrease in Asset Management revenues. Financial Services revenues decreased principally as a result of a net $987 million credit valuation adjustment loss on AIGFP's assets and liabilities which are measured at fair value. AIGFP's revenues were also negatively affected by the disruption in the credit markets and the general decline in liquidity in the marketplace. Asset Management revenues decreased primarily as a result of lower partnership income related to the Spread-Based Investment Business.

Other Income decreased in the nine-month period ended September 30, 2008 compared to the same period in 2007 primarily due to a $1.7 billion decrease in Financial Services revenues and a $1.2 billion decrease in Asset Management revenues. Financial Services revenues decreased principally as a result of a net $1.4 billion credit valuation adjustment loss on AIGFP's assets and liabilities which are measured at fair value. Asset Management revenues decreased primarily as a result of lower guaranteed investment contract revenue due to lower partnership income.

Incurred Policy Losses and Benefits

Incurred policy losses and benefits increased in the three-month period ended September 30, 2008 compared to the same period in 2007 primarily due to a $1.2 billion increase in Commercial Insurance as a result of $1.1 billion of catastrophe-related losses principally from hurricanes Ike and Gustav in 2008, a $464 million increase in Foreign General Insurance as a result of an increase in frequency of smaller claims and higher catastrophe-related losses primarily from hurricanes Ike and Gustav and a $461 million increase in Mortgage Guaranty reflecting the deterioration of the U.S. housing market. Increases in incurred policy losses and benefits of $1.0 billion in Life Insurance & Retirement Services were more than offset by a reduction in losses and benefits arising from policyholder trading losses of $1.7 billion discussed above in Net Investment Income.

Incurred policy losses and benefits increased in the nine-month period compared to the same period in 2007 primarily due to a $1.6 billion increase in Commercial Insurance as a result of higher catastrophe-related losses principally from hurricanes Ike and Gustav in 2008, a $1.2 billion increase in Foreign General Insurance as a result of higher catastrophe-related losses and severe but non-catastrophic losses, and a $1.4 billion increase in Mortgage Guaranty reflecting the deterioration of the U.S. housing market. Increases in incurred policy losses and benefits of $2.7 billion in Life Insurance & Retirement Services were more than offset by a reduction in losses and benefits arising from policyholder trading losses of $3.8 billion discussed above in Net Investment Income.

Policy Acquisition and Other Insurance Expenses

Policy acquisition and other insurance expenses increased in the three-month period ended September 30, 2008 compared to the same period in 2007 primarily due to a $785 million increase in General Insurance expenses and a $777 million increase in Life Insurance & Retirement Services expenses. General Insurance expenses increased primarily due to the recognition of a premium deficiency reserve of $453 million related to United Guaranty Corporation's (UGC) second-lien business. Life Insurance & Retirement Services expenses increased principally as a result of the effect of foreign exchange, growth in the business and the effect of FAS 159 implementation.

Policy acquisition and other insurance expenses increased in the nine-month period ended September 30, 2008 compared to the same period in 2007 primarily due to a $1.6 billion increase in General Insurance expenses and a $1.5 billion increase in Life Insurance & Retirement Services expenses. General Insurance expenses increased primarily due to the recognition of a premium deficiency reserve of $453 million related to UGC's second-lien business, a $432 million increase in compensation-related expenses, and a $275 million change in DAC. Life Insurance & Retirement Services expenses increased primarily due to the effect of foreign exchange, growth in the business and the effect of FAS 159 implementation.

Interest Expense

Interest expense increased in the three- and nine-month periods ended September 30, 2008 compared to the same periods in 2007 reflecting higher borrowings, including interest on the debt and Equity Units from the dates of issuance in May 2008 and borrowings under the Fed facility. Interest expense also includes amortization of the prepaid commitment assets in connection

with the Series C Preferred Stock.

Other Expenses

Other Expenses decreased in the three-month period ended September 30, 2008 compared to the same period in 2007 primarily due to a $563 million reversal of accrued compensation expense under AIGFP's various deferred compensation plans and special incentive plan as a result of significant losses recognized by AIGFP in 2008. Offsetting this reversal were goodwill impairment charges of $341 million and $91 million related to Consumer Finance and Capital Markets, respectively, recognized in the third quarter 2008, resulting from the downturn in the housing markets, the credit crisis and the intent to unwind certain AIGFP businesses. An increase in AGF's provision for finance receivable losses of $198 million also contributed to the decline.

Other Expenses increased in the nine-month period ended September 30, 2008 compared to the same period in 2007 primarily as a result of the goodwill impairment charges mentioned above, an increase in AIGFP's other operating expenses due to professional service fees and an increase in AGF's provision for finance receivable losses of $471 million. Partially offsetting these increases was the reversal of AIGFP deferred compensation and special incentive plan discussed above.

Income Taxes (Benefits)

The effective tax rate on the pre-tax loss for the three-month period ended September 30, 2008 was 12.3 percent. The effective tax rate was lower than the statutory rate of 35 percent due primarily to $6.9 billion of deferred tax expense recorded during the third quarter, comprising $3.6 billion of deferred tax expense attributable to the potential sale of foreign businesses, and a $3.3 billion valuation allowance to reduce tax benefits on capital losses to the amount that AIG believes is more likely than not to be realized.

The effective tax rate on the pre-tax loss for the nine-month period ended September 30, 2008 was 21.5 percent and was also lower than the statutory rate primarily due to the $6.9 billion of deferred tax expense, which is discussed above, as well as other tax charges recorded.

The effective tax rates on pre-tax income for the three- and nine-month periods ended September 30, 2007 were 30.0 percent and 28.0 percent, respectively. These effective tax rates were lower than the statutory rate due primarily to benefits from remediation adjustments and the recognition of tax benefits associated with the SICO Plan for which the compensation expense was recognized in prior years.

Realization of the deferred tax asset depends on AIG's ability to generate sufficient taxable income of the appropriate character within the carryforward periods of the jurisdictions in which the net operating losses and deductible temporary differences were incurred. AIG assessed its ability to realize the deferred tax asset of $19.1 billion and concluded a $3.3 billion valuation allowance was required to reduce the deferred tax asset to an amount AIG believes is more likely than not to be realized.

When making its assessment, AIG considered future reversals of existing taxable temporary differences, future GAAP taxable income and tax-planning strategies AIG would implement, if necessary, to realize the net deferred tax asset.

In assessing future GAAP taxable income, AIG considered its strong earnings history exclusive of the recent losses on the super senior credit default swap portfolio and from the securities lending program, with respect to which AIG is entering into transactions with the NY Fed to limit exposure to future losses. AIG also considered taxable income from the sales of businesses under its asset disposition plan, the continuing earnings strength of the insurance businesses it intends to retain and its recently announced debt and preferred stock transactions with the NY Fed, together with other actions AIG is taking, when assessing the ability to generate sufficient future taxable income during the relevant carryforward periods to realize the deferred tax asset.

Segment Results

The following table summarizes the operations of each operating segment. (See also Note 2 to the Consolidated Financial Statements.)

	Three Months Ended September 30,		Percentage	Nine Months Ended September 30,		Percentage
(in millions)	**2008**	2007	Increase/ (Decrease)	**2008**	2007	Increase/ (Decrease)
Total revenues (a)(b)(e):						
General Insurance	**$ 10,808**	$12,758	(15)%	**$ 35,854**	$38,589	(7)%
Life Insurance & Retirement Services	**(4,642)**	12,632	–	**14,271**	40,337	(65)
Financial Services (c)(d)	**(5,851)**	2,785	–	**(16,016)**	7,109	–
Asset Management	**10**	1,519	(99)	**658**	4,969	(87)
Other	**451**	13	–	**531**	407	30
Consolidation and eliminations	**122**	129	–	**(436)**	220	–
Total	**$ 898**	$29,836	(97)%	**$ 34,862**	$91,631	(62)%
Operating income (loss) (a)(b)(e):						
General Insurance	**$ (2,557)**	$ 2,439	–%	**$ (393)**	$ 8,511	–%
Life Insurance & Retirement Services	**(15,329)**	1,999	–	**(19,561)**	6,900	–
Financial Services (c)(d)	**(8,203)**	669	–	**(22,880)**	1,008	–
Asset Management	**(1,144)**	121	–	**(2,709)**	1,806	–
Other	**(1,416)**	(627)	–	**(2,899)**	(1,557)	–
Consolidation and eliminations	**464**	278	–	**237**	711	–
Total	**$(28,185)**	$ 4,879	–%	**$(48,205)**	$17,379	–%

(a) Includes gains (losses) from hedging activities that did not qualify for hedge accounting treatment under FAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FAS 133), including the related foreign exchange gains and losses. For the three-month periods ended September 30, 2008 and 2007, the effect was $1.2 billion and $(178) million, respectively, in both revenues and operating income (loss). For the nine-month periods ended September 30, 2008 and 2007, the effect was $705 million and $(1.1) billion, respectively, in both revenues and operating income (loss). These amounts result primarily from interest rate and foreign currency derivatives that are effective economic hedges of investments and borrowings.

(b) Includes other-than-temporary impairment charges. Refer to Invested Assets — Portfolio Review — Other-Than-Temporary Impairments for further discussion.

(c) Includes gains (losses) from hedging activities that did not qualify for hedge accounting treatment under FAS 133, including the related foreign exchange gains and losses. For the three-month periods ended September 30, 2008 and 2007, the effect was $217 million and $353 million, respectively, in both revenues and operating income (loss). For the nine-month periods ended September 30, 2008 and 2007, the effect was $18 million and $(250) million, respectively, in both revenues and operating income (loss). These amounts result primarily from interest rate and foreign currency derivatives that are effective economic hedges of investments and borrowings.

(d) Includes unrealized market valuation losses of $7.1 billion and $21.7 billion for the three- and nine-month periods ended September 30, 2008, respectively, and $352 million for the three- and nine-month periods ended September 30, 2007, on AIGFP's super senior credit default swap portfolio.

(e) To better align financial reporting with the manner in which AIG's chief operating decision maker manages the business, beginning in the third quarter of 2008, AIG's own credit risk valuation adjustments on intercompany transactions are excluded from segment revenues and operating income.

General Insurance Operations

AIG's General Insurance subsidiaries are multiple line companies writing substantially all lines of property and casualty insurance and various personal lines both domestically and abroad and constitute the AIG Property Casualty Group (formerly known as Domestic General Insurance) and the Foreign General Insurance Group.

AIG Property Casualty Group is comprised of Commercial Insurance, Transatlantic, Personal Lines and Mortgage Guaranty businesses.

Commercial Insurance writes substantially all classes of business insurance, accepting such business mainly from insurance brokers. This provides Commercial Insurance the opportunity to select specialized markets and retain underwriting control. Any licensed broker is able to submit business to Commercial Insurance without the traditional agent-company contractual relationship, but such broker usually has no authority to commit Commercial Insurance to accept a risk.

Transatlantic Holdings, Inc. (Transatlantic) subsidiaries offer reinsurance capacity on both a treaty and facultative basis both in the U.S. and abroad. Transatlantic structures programs for a full range of property and casualty products with an emphasis on specialty risk.

AIG's Personal Lines operations provide automobile insurance through aigdirect.com, its direct marketing distribution channel, and the Agency Auto Division, its independent agent/broker distribution channel. It also provides a broad range of coverages for high net worth individuals through the AIG Private Client Group (Private Client Group). Coverages for the Personal Lines operations are written predominantly in the United States.

The main business of the subsidiaries of UGC is the issuance of residential mortgage guaranty insurance, both domestically and internationally, that covers the first loss for credit defaults on high loan-to-value conventional first-lien mortgages for the purchase or refinance of one to four family residences.

On September 15, 2008, United Guaranty Residential Insurance Company (UGRIC) and United Guaranty Mortgage Indemnity Company (UGMIC) were downgraded from AA+ to A+ by S&P. As a result of the downgrade below the AA- level, the companies were required to submit a remediation plan to Fannie Mae and Freddie Mac. All U.S. based mortgage insurers are currently subject to a Government Sponsored Enterprise (GSE) remediation plan as a result of industry-wide rating agency downgrades. UGC's plan was timely submitted and is awaiting GSE approval. UGRIC and UGMIC continue to write new domestic first-lien mortgage insurance and remain as eligible mortgage insurers with Fannie Mae and Freddie Mac.

AIG's Foreign General Insurance Group writes both commercial and consumer lines of insurance which is primarily underwritten through American International Underwriters (AIU), a marketing unit consisting of wholly owned agencies and insurance companies. The Foreign General Insurance Group also includes business written by AIG's foreign-based insurance subsidiaries.

General Insurance Results

General Insurance operating income is comprised of statutory underwriting profit (loss), changes in DAC, net investment income and net realized capital gains and losses. Operating income (loss), as well as net premiums written, net premiums earned, net investment income and net realized capital gains (losses) and statutory ratios were as follows:

(in millions, except ratios)	Three Months Ended September 30, 2008	2007	Percentage Increase/ (Decrease)	Nine Months Ended September 30, 2008	2007	Percentage Increase/ (Decrease)
Net premiums written:						
AIG Property Casualty Group						
Commercial Insurance	**$ 5,597**	$ 6,012	(7)%	**$16,698**	$18,460	(10)%
Transatlantic	**1,094**	985	11	**3,118**	2,952	6
Personal Lines	**1,108**	1,253	(12)	**3,626**	3,685	(2)
Mortgage Guaranty	**280**	303	(8)	**872**	841	4
Foreign General Insurance	**3,647**	3,270	12	**11,712**	10,130	16
Total	**$11,726**	$11,823	(1)%	**$36,026**	$36,068	–%
Net premiums earned:						
AIG Property Casualty Group						
Commercial Insurance	**$ 5,735**	$ 5,942	(3)%	**$17,064**	$17,919	(5)%
Transatlantic	**1,027**	960	7	**3,067**	2,873	7
Personal Lines	**1,183**	1,193	(1)	**3,591**	3,516	2
Mortgage Guaranty	**254**	226	12	**779**	657	19
Foreign General Insurance	**3,532**	3,112	13	**10,740**	9,050	19
Total	**$11,731**	$11,433	3%	**$35,241**	$34,015	4%
Net investment income:						
AIG Property Casualty Group						
Commercial Insurance	**$ 512**	$ 854	(40)%	**$ 1,842**	$ 2,871	(36)%
Transatlantic	**111**	113	(2)	**348**	348	–
Personal Lines	**53**	59	(10)	**166**	173	(4)
Mortgage Guaranty	**48**	42	14	**136**	118	15
Foreign General Insurance	**5**	325	(99)	**604**	1,071	(44)
Reclassifications and eliminations	**6**	1	–	**11**	4	175
Total	**$ 735**	$ 1,394	(47)%	**$ 3,107**	$ 4,585	(32)%
Net realized capital gains (losses)	**$ (1,658)**	$ (69)	–%	**$ (2,494)**	$ (11)	–%
Operating income (loss):						
AIG Property Casualty Group						
Commercial Insurance	**$ (1,109)**	$ 1,829	–%	**$ 57**	$ 5,662	(99)%
Transatlantic	**(155)**	189	–	**148**	508	(71)
Personal Lines	**23**	28	(18)	**47**	252	(81)
Mortgage Guaranty	**(1,118)**	(216)	–	**(1,990)**	(289)	–
Foreign General Insurance	**(209)**	607	–	**1,323**	2,383	(44)
Reclassifications and eliminations	**11**	2	450	**22**	(5)	–
Total	**$ (2,557)**	$ 2,439	–%	**$ (393)**	$ 8,511	–%
Statutory underwriting profit (loss) *(b)* :						
AIG Property Casualty Group						
Commercial Insurance	**$ (426)**	$ 1,014	–%	**$ 149**	$ 2,744	(95)%
Transatlantic	**(96)**	53	–	**24**	106	(77)
Personal Lines	**9**	(40)	–	**(96)**	49	–
Mortgage Guaranty	**(1,155)**	(270)	–	**(2,126)**	(438)	–
Foreign General Insurance	**74**	266	(72)	**881**	1,039	(15)
Total	**$ (1,594)**	$ 1,023	–%	**$ (1,168)**	$ 3,500	–%
AIG Property Casualty Group:						
Loss Ratio	**92.2**	69.2		**83.8**	68.8	
Expense Ratio	**28.6**	21.1		**24.7**	20.5	
Combined Ratio	**120.8**	90.3		**108.5**	89.3	
Foreign General Insurance:						
Loss Ratio	**59.3**	52.4		**54.9**	51.7	
Expense Ratio *(a)*	**37.4**	37.1		**33.8**	32.9	
Combined ratio	**96.7**	89.5		**88.7**	84.6	
Consolidated:						
Loss Ratio	**82.3**	64.7		**75.0**	64.3	
Expense Ratio	**31.3**	25.5		**27.7**	24.0	
Combined Ratio	**113.6**	90.2		**102.7**	88.3	

(a) Includes amortization of advertising costs.

(b) Statutory underwriting profit (loss) is a measure that U.S. domiciled insurance companies are required to report to their regulatory authorities. The following table reconciles statutory underwriting profit (loss) to operating income (loss) for General Insurance:

TARP Capital Purchase Program

Senior Preferred Stock and Warrants

Summary of Senior Preferred Terms

Issuer: Qualifying Financial Institution ("QFI") means (i) any U.S. bank or U.S savings association not controlled by a Bank Holding Company ("BHC") or Savings and Loan Company ("SLHC"); (ii) any top-tier U.S. BHC, (iii) any top-tier U.S. SLHC which engages solely or predominately in activities that are permitted for financial holding companies under relevant law; and (iv) any U.S. bank or U.S. savings association controlled by a U.S. SLHC that does not engage solely or predominately in activities that are permitted for financial holding companies under relevant law. QFI shall not mean any BHC, SLHC, bank or savings association controlled by a foreign bank or company. For purposes of this program, "U.S. bank", "U.S. savings association", "U.S. BHC" and "U.S. SLHC" means a bank, savings association, BHC or SLHC organized under the laws of the United States or any State of the United States, the District of Columbia, any territory or possession of the United States, Puerto Rico, Northern Mariana Islands, Guam, American Samoa, or the Virgin Islands. **The United States Department of the Treasury will determine eligibility and allocation for QFIs after consultation with the appropriate Federal banking agency.**

Initial Holder: United States Department of the Treasury (the "UST").

Size: QFIs may sell preferred to the UST subject to the limits and terms described below.

Each QFI may issue an amount of Senior Preferred equal to not less than 1% of its risk-weighted assets and not more than the lesser of (i) $25 billion and (ii) 3% of its risk-weighted assets.

Security: Senior Preferred, liquidation preference $1,000 per share. (Depending upon the QFI's available authorized preferred shares, the UST may agree to purchase Senior Preferred with a higher liquidation preference per share, in which case the UST may require the QFI to appoint a depositary to hold the Senior Preferred and issue depositary receipts.)

Ranking: Senior to common stock and pari passu with existing preferred shares other than preferred shares which by their terms rank junior to any existing preferred shares.

Regulatory Capital Status: Tier 1.

Term: Perpetual life.

Dividend: The Senior Preferred will pay cumulative dividends at a rate of 5% per annum until the fifth anniversary of the date of this investment and thereafter at a rate of 9% per annum. For Senior Preferred issued by banks which are not subsidiaries of holding companies, the Senior Preferred will pay non-cumulative dividends at a rate of 5% per annum until the fifth anniversary of the date of this investment and thereafter at a rate of 9% per annum. Dividends will be payable quarterly in arrears on February 15, May 15, August 15 and November 15 of each year.

Redemption: Senior Preferred may not be redeemed for a period of three years from the date of this investment, except with the proceeds from a Qualified Equity Offering (as defined below) which results in aggregate gross proceeds to the QFI of not less than 25% of the issue price of the Senior Preferred. After the third anniversary of the date of this investment, the Senior Preferred may be redeemed, in whole or in part, at any time and from time to time, at the option of the QFI. All redemptions of the Senior Preferred shall be at 100% of its issue price, plus (i) in the case of cumulative Senior Preferred, any accrued and unpaid dividends and (ii) in the case of non-cumulative Senior Preferred, accrued and unpaid dividends for the then current dividend period (regardless of whether any dividends are actually declared for such dividend period), and shall be subject to the approval of the QFI's primary federal bank regulator.

"Qualified Equity Offering" shall mean the sale by the QFI after the date of this investment of Tier 1 qualifying perpetual preferred stock or common stock for cash.

Following the redemption in whole of the Senior Preferred held by the UST, the QFI shall have the right to repurchase any other equity security of the QFI held by the UST at fair market value.

Restrictions on Dividends: For as long as any Senior Preferred is outstanding, no dividends may be declared or paid on junior preferred shares, preferred shares ranking pari passu with the Senior Preferred, or common shares (other than in the case of pari passu preferred shares, dividends on a pro rata basis with the Senior Preferred), nor may the QFI repurchase or redeem any junior preferred shares, preferred shares ranking pari passu with the Senior Preferred or common shares, unless (i) in the case of cumulative Senior

Preferred all accrued and unpaid dividends for all past dividend periods on the Senior Preferred are fully paid or (ii) in the case of non-cumulative Senior Preferred the full dividend for the latest completed dividend period has been declared and paid in full.

Common dividends: The UST's consent shall be required for any increase in common dividends per share until the third anniversary of the date of this investment unless prior to such third anniversary the Senior Preferred is redeemed in whole or the UST has transferred all of the Senior Preferred to third parties.

Repurchases: The UST's consent shall be required for any share repurchases (other than (i) repurchases of the Senior Preferred and (ii) repurchases of junior preferred shares or common shares in connection with any benefit plan in the ordinary course of business consistent with past practice) until the third anniversary of the date of this investment unless prior to such third anniversary the Senior Preferred is redeemed in whole or the UST has transferred all of the Senior Preferred to third parties. In addition, there shall be no share repurchases of junior preferred shares, preferred shares ranking pari passu with the Senior Preferred, or common shares if prohibited as described above under "Restrictions on Dividends".

Voting rights: The Senior Preferred shall be non-voting, other than class voting rights on (i) any authorization or issuance of shares ranking senior to the Senior Preferred, (ii) any amendment to the rights of Senior Preferred, or (iii) any merger, exchange or similar transaction which would adversely affect the rights of the Senior Preferred.

If dividends on the Senior Preferred are not paid in full for six dividend periods, whether or not consecutive, the Senior Preferred will have the right to elect 2 directors. The right to elect directors will end when full dividends have been paid for four consecutive dividend periods.

Transferability: The Senior Preferred will not be subject to any contractual restrictions on transfer. The QFI will file a shelf registration statement covering the Senior Preferred as promptly as practicable after the date of this investment and, if necessary, shall take all action required to cause such shelf registration statement to be declared effective as soon as possible. The QFI will also grant to the UST piggyback registration rights for the Senior Preferred and will take such other steps as may be reasonably requested to facilitate the transfer of the Senior Preferred including, if requested by the UST, using reasonable efforts to list the Senior Preferred on a national securities exchange. If requested by the UST, the QFI will appoint a depositary to hold the Senior Preferred and issue depositary receipts.

Executive Compensation: As a condition to the closing of this investment, the QFI and its senior executive officers covered by the EESA shall modify or terminate all benefit plans, arrangements and agreements (including golden parachute agreements) to the extent necessary to be in compliance with, and following the closing and for so long as UST holds any equity or debt securities of the QFI, the QFI shall agree to be bound by, the executive compensation and corporate governance requirements of Section 111 of the EESA and any guidance or regulations issued by the Secretary of the Treasury on or prior to the date of this investment to carry out the provisions of such subsection. As an additional condition to closing, the QFI and its senior executive officers covered by the EESA shall grant to the UST a waiver releasing the UST from any claims that the QFI and such senior executive officers may otherwise have as a result of the issuance of any regulations which modify the terms of benefits plans, arrangements and agreements to eliminate any provisions that would not be in compliance with the executive compensation and corporate governance requirements of Section 111 of the EESA and any guidance or regulations issued by the Secretary of the Treasury on or prior to the date of this investment to carry out the provisions of such subsection.

Summary of Warrant Terms

Warrant: The UST will receive warrants to purchase a number of shares of common stock of the QFI having an aggregate market price equal to 15% of the Senior Preferred amount on the date of investment, subject to reduction as set forth below under "Reduction". The initial exercise price for the warrants, and the market price for determining the number of shares of common stock subject to the warrants, shall be the market price for the common stock on the date of the Senior Preferred investment (calculated on a 20-trading day trailing average), subject to customary anti-dilution adjustments. The exercise price shall be reduced by 15% of the original exercise price on each six-month anniversary of the issue date of the warrants if the consent of the QFI stockholders described below has not been received, subject to a maximum reduction of 45% of the original exercise price.

Term: 10 years

Exercisability: Immediately exercisable, in whole or in part

Transferability: The warrants will not be subject to any contractual restrictions on transfer; provided that the UST may only transfer or exercise an aggregate of one-half of the warrants prior to the earlier of (i) the date on which the QFI has received aggregate gross proceeds of not less than 100% of the issue price

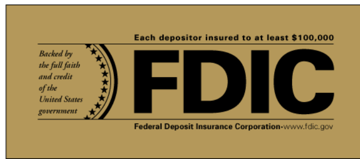
of the Senior Preferred from one or more Qualified Equity Offerings and (ii) December 31, 2009. The QFI will file a shelf registration statement covering the warrants and the common stock underlying the warrants as promptly as practicable after the date of this investment and, if necessary, shall take all action required to cause such shelf registration statement to be declared effective as soon as possible. The QFI will also grant to the UST piggyback registration rights for the warrants and the common stock underlying the warrants and will take such other steps as may be reasonably requested to facilitate the transfer of the warrants and the common stock underlying the warrants. The QFI will apply for the listing on the national exchange on which the QFI's common stock is traded of the common stock underlying the warrants and will take such other steps as may be reasonably requested to facilitate the transfer of the warrants or the common stock.

Voting: The UST will agree not to exercise voting power with respect to any shares of common stock of the QFI issued to it upon exercise of the warrants.

Reduction: In the event that the QFI has received aggregate gross proceeds of not less than 100% of the issue price of the Senior Preferred from one or more Qualified Equity Offerings on or prior to December 31, 2009, the number of shares of common stock underlying the warrants then held by the UST shall be reduced by a number of shares equal to the product of (i) the number of shares originally underlying the warrants (taking into account all adjustments) and (ii) 0.5.

Consent: In the event that the QFI does not have sufficient available authorized shares of common stock to reserve for issuance upon exercise of the warrants and/or stockholder approval is required for such issuance under applicable stock exchange rules, the QFI will call a meeting of its stockholders as soon as practicable after the date of this investment to increase the number of authorized shares of common stock and/or comply with such exchange rules, and to take any other measures deemed by the UST to be necessary to allow the exercise of warrants into common stock.

Substitution: In the event the QFI is no longer listed or traded on a national securities exchange or securities association, or the consent of the QFI stockholders described above has not been received within 18 months after the issuance date of the warrants, the warrants will be exchangeable, at the option of the UST, for senior term debt or another economic instrument or security of the QFI such that the UST is appropriately compensated for the value of the warrant, as determined by the UST.



Application Guidelines for TARP Capital Purchase Program

This application is used to request participation in the Treasury Capital Purchase Program (CPP). Under the CPP, the U.S. Department of the Treasury (Treasury) may purchase qualifying capital in U.S. banking organizations.

The application must be submitted to the appropriate Federal banking agency (FBA) for the applicant. If the applicant is a bank holding company, the application should be submitted to both the applicant's holding company supervisor and the supervisor of the largest insured depository institution controlled by the applicant. All inquiries regarding preparation of the application should be directed to the appropriate FBA for the applicant. All applications must be submitted no later than 5pm (EST), November 14, 2008.

More detailed information, including submission instructions, can be found at the applicable FBA's website:

1. For the Federal Deposit Insurance Corporation: www.fdic.gov
2. For the Federal Reserve: www.federalreserve.gov
3. For the Office of the Comptroller of the Currency: www.occ.treas.gov
4. For the Office of Thrift Supervision: www.ots.treas.gov

The terms of the CPP are described generally in this application. However, this description is not binding on the Treasury and is intended to provide general information only. The actual terms and conditions of the CPP are contained in documentation that will be available from the Treasury Department on its web site at http://www.treas.gov/initiatives/eesa/.

Eligible Institutions

The CPP is available to bank holding companies, financial holding companies, insured depository institutions and savings and loan holding companies that engage solely or predominately in activities that are permissible for financial holding companies under relevant law. To qualify, the applicant must be established and operating in the United States and may not be controlled by a foreign bank or company.

Institutions must consult with their appropriate FBA prior to submitting this application.

Certain Conditions for Participation in the CPP

To be eligible for the CPP, the applicant must receive the approval of the Treasury. In addition, the applicant must agree to certain terms and conditions and make certain representations and warranties described in various agreements prepared by the Treasury and available on Treasury's website. A summary term sheet is currently available on Treasury's website and a detailed investment agreement and associated documentation will be posted soon. Each applicant must obtain and review a copy of these agreements and agree to all of the terms and conditions, including representations and warranties, contained in these agreements. In the event the applicant files an application with the appropriate FBA prior to the availability of the investment agreement, the applicant must file an amended application which includes updated responses to any items in the application that required prior review of the investment agreement.

In the event that an applicant cannot, by November 14, 2008, take action to be in compliance with all of the terms and conditions, including the representations and warranties, contained in the Treasury agreements, the applicant must provide an explanation of the condition or conditions that cannot be met and the reasons the condition or conditions cannot be met. This explanation must be attached to the application. Failure to agree to all terms and conditions may result in disqualification from the CPP.

If the applicant receives preliminary approval to participate in the CPP from the Treasury, the applicant will have 30 days from the date of notification to submit the investment agreements and related documentation.

Among the conditions to participation in the CPP is the requirement that, for so long as the Treasury owns shares or warrants in the applicant, certain senior officers of the applicant meet standards established by the Treasury for executive compensation in certain circumstances. These standards are explained on the Treasury web site at: http://www.treas.gov/initiatives/eesa/executivecompensation.shtml.

For the first three years that the Treasury owns shares or warrants in the applicant, the applicant may not increase its dividend payments on common shares without the permission of the Treasury. In addition, the applicant may not repurchase or redeem any junior preferred shares, preferred shares ranking *pari passu* with the Senior Preferred, trust preferred, or common shares (other than in connection with certain employee benefit programs) during the first three years of the investment without the permission of the Treasury.

Form of Capital Qualifying for Purchase

All capital purchases will occur at the highest-tier holding company in cases in which the banking organization has a bank holding company or a savings and loan holding company. In these cases, the capital eligible for purchase by the Treasury under the CPP is cumulative perpetual preferred stock of the highest tier holding company. The shares must be *pari passu* with the most senior preferred shares available by the applicant.

In the case of an insured depository institution that is not controlled by a company, the capital eligible for purchase by the Treasury under the CPP is non-cumulative perpetual preferred stock

of the insured depository institution. The shares must be *pari passu* with the most senior preferred shares available by the applicant.

The maximum amount of capital eligible for purchase by the Treasury under the CPP is the lesser of (i) an amount equal to 3 percent of the Total Risk-Weighted Assets of the applicant or (ii) $25 billion. The minimum amount eligible for purchase under the CPP is the amount equal to 1 percent of the Total Risk-Weighted Assets of the applicant. All measurements will be based on the information contained in the latest quarterly supervisory report filed by the applicant with its appropriate FBA, updated to reflect events materially affecting the financial condition of the applicant occurring since the filing of such report.

The shares purchased by the Treasury will have a dividend rate of 5 percent per year until the fifth anniversary of the date of the investment and a dividend rate of 9 percent per year thereafter. Dividends not paid must cumulate over the life of the investment in the case of shares purchased from a holding company for an insured depository institution. Shares may be redeemed by the applicant during the first three years following the investment only from the proceeds of a qualifying stock issuance by the applicant.

In all cases, the Treasury also must obtain warrants for common stock of the applicant. The terms of the warrants are explained in the Treasury agreements available on the Treasury web site. In general, the warrants must be convertible into an amount of common stock of the applicant equivalent in value to 15 percent of the amount of the capital purchased by the Treasury from the applicant under the CPP, calculated based on the average of closing prices of the common stock on the 20 trading days ending on and including the last trading day prior to the date of execution of the Purchase Agreement.

Other Information

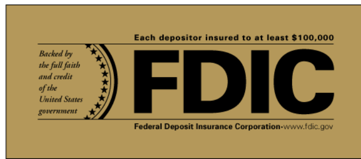
The applicant must identify and describe any mergers, acquisitions, or other capital raisings that are currently pending or are under negotiation and the expected consummation date.

Confidentiality

Any applicant desiring confidential treatment of specific portions of the application must submit a request in writing with the application. The request must discuss the justification for the requested treatment. The applicant's reasons for requesting confidentiality should specifically demonstrate the harm (for example, loss of competitive position, invasion of privacy) that would result from public release of information (5 U.S.C. 552). Information for which confidential treatment is requested should be: (1) specifically identified in the public portion of the application (by reference to the confidential section); (2) separately bound; and (3) labeled "Confidential." The applicant should follow the same procedure when requesting confidential treatment for the subsequent filing of supplemental information to the application.

The applicant should contact the appropriate regulatory agency for specific instructions regarding requests for confidential treatment. The appropriate regulatory agency will determine

whether the information will be treated as confidential and will advise the applicant of any decision to make available to the public information labeled as "Confidential."



Application for TARP Capital Purchase Program (CPP)

Please complete the following information and follow the submission instructions as described on your Federal banking agency's website. In addition to completing the information on this form, please provide a description of any mergers, acquisitions, or other capital raisings that are currently pending or are under negotiation and the expected consummation date (no longer than 1 page).

In the event the applicant files an application with the appropriate Federal banking agency prior to the availability of the investment agreement, the applicant must file an amended application which includes updated responses to any items in the application that required prior review of the investment agreement.

Institution Name: ______________________________

Address of Institution: ______________________________

____

Primary Contact Name: ______________________________

Primary Contact Phone Number: ______________________________

Primary Contact Fax Number: ______________________________

Primary Contact Email Address: ______________________________

Secondary Contact Name: ______________________________

Secondary Contact Phone Number: ______________________________

Secondary Contact Fax Number: ______________________________

Secondary Contact Email Address: ______________________________

RSSD, Holding Company Docket Number and / or FDIC Certificate Number, As Relevant: ______________________

Amount of Preferred Shares Requested: ______________________

Amount Of Institution's Authorized But Unissued Preferred Stock Available For Purchase: ______________________

Amount Of Institution's Authorized But Unissued Common Stock: ______________________

Amount Of Total Risk-Weighted Assets As Reported On The Holding Company's Or Applicable Institution's Most Recent FR-Y9, Call Report, Or TFR, As Relevant: ______________________

Institution Has Reviewed The Investment Agreements And Related Documentation On Treasury's Website (Yes/No): ______________________

Describe Any Condition, Including A Representation Or Warranty, Contained In The Investment Agreements And Related Documentation, The Institution Believes it Cannot Comply With By November 14, 2008 And Provide A Timeline For Reaching Compliance[1]: ______________________

Type of Company[2]: ______________________

Signature of Chief Executive Officer (or Authorized Designee): ______________________

Date of Signature: ______________________

[1] May be provided as an attachment, no longer than 1 page
[2] Publicly Traded Stock Company; Stock Company Without Publicly Traded Shares; Other (please specify)

Private Bank Program Q&A

Q. What is the deadline for applying for the private CPP program?

Applications must be filed by December 8, 2008.

Q. How do I apply?

Applicants should complete the application and follow the procedures that can be found on the applicable federal banking agency website or on the Treasury website at http://www.treasury.gov/initiatives/eesa/application-documents.shtml.

Q. **What if an institution has a bank or thrift holding company application pending with a federal banking regulator?**

Institutions that have filed a bank or thrift holding company application on or before December 8, 2008 may apply to the TARP program through their federal banking regulator on a conditional basis by the applicable deadline. In order to qualify for the TARP program, the applicant company must apply for approval to become a bank or thrift holding company through ownership of an U.S. bank or savings association that was in existence on or before December 8, 2008. Final approval of the holding company application must be granted by the applicable federal banking agency by January 15, 2009. Funding will not be provided prior to consummation of the transaction for which bank or thrift holding company status was necessary. Any bank and thrift holding company, which received funding under TARP, must maintain its status as a bank or thrift holding company for as long as Treasury holds preferred stock and/or warrants in the company. A bank or thrift holding company seeking to terminate its status as such must fully redeem all preferred stock and warrants held by Treasury prior to terminating its status.

Q. Will you require the issuance of Warrant Preferred from all QFIs participating in the Capital Purchase Program?

Treasury has discretion to exempt certain investments from the warrant requirements (Sec. 113(d) (3) of the Emergency Economic Stabilization Act of 2008). We are using this discretion conservatively because of our interest in providing a return for the taxpayer in making these investments. For this reason, we have determined not to require a warrant to purchase additional preferred stock for a limited class of qualifying institutions. If a QFI meets the following requirements, then the UST will not require the issuance of the Warrant Preferred shares: the size of the investment must be $50 million or less and the QFI must be a certified Community Development Financial Institution (CDFI). QFIs must file an application for certification as a CDFI by December 8, 2008. If a QFI has applied for CDFI certification, and it is eligible for funding under the CPP program, it will receive conditional approval, which will

be contingent on the QFI receiving the CDFI certification. The CDFI certification must be approved by January 15, 2009.

Q. **What is a CDFI and where can I get additional information about them?**

A CDFI is a specialized financial institution that works in market niches that are underserved by traditional financial institutions. CDFIs provide a unique range of financial products and services in economically distressed target markets, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers, flexible underwriting and risk capital for needed community facilities, and technical assistance, commercial loans and investments to small start-up or expanding businesses in low-income areas.

Q. **How do I get information about becoming a CDFI?**

Additional information about becoming a CDFI can be found at http://www.cdfifund.gov/

Q. Must I currently be a CDFI to qualify for the exemption from the Warrant Preferred?

In order to qualify for the exemption, you must have a completed application to be a CDFI at the time your application is filed with the CPP. In order to qualify for the exemption, your CDFI application must be approved at the time of the closing of the investment. The CDFI Fund has pledged that it will streamline the certification process to 30 days in order to qualify for this exemption.

Q. Does this term sheet and deadline apply to S-Corporations and mutual organizations?

No. These structures are still under consideration. The deadline for this program will not apply to programs for S-Corporations and mutuals.

<u>Summary of Terms</u>

Eligible Asset Guarantee

Eligible Assets:	Asset pool consisting of loans and securities backed by residential real estate and commercial real estate, and their associated hedges, as agreed, and other such assets as the U.S. Government (USG) has agreed to guarantee. Each specific asset must be identified on signing of guarantee agreement. Assets will remain on the books of institution but will be appropriately "ring-fenced."
Size:	Up to $306 bn in assets to be guaranteed (based on valuation agreed upon between institution and USG).
Term of Guarantee:	FDIC standard loss-sharing protocol: Guarantee is in place for 10 years for residential assets, 5 years for non-residential assets.
Deductible:	Institution absorbs all losses in portfolio up to $29 bn (in addition to existing reserves) Any losses in portfolio in excess of that amount are shared USG (90%) and institution (10%). USG share will be allocated as follows: UST (via TARP) second loss up to $5 bn; FDIC takes the third loss up to $10 bn;
Financing:	Federal Reserve funds remaining pool of assets with a non-recourse loan, subject to the institution's 10% loss sharing, at a floating rate of OIS plus 300bp. Interest payments are with recourse to the institution.
Fee for Guarantee - Preferred Stock:	Institution will issue $7 bn of preferred stock with an 8% dividend rate (under terms described below). $4 bn of preferred will be issued to UST. $3 bn will be issued to the FDIC.
Management of Assets:	USG will provide institution with a template to manage guaranteed assets This template will include the use of mortgage modification procedures adopted by the FDIC, unless otherwise agreed.
Risk Weighting:	Institution will retain the income stream from the guaranteed assets. Risk weighting for assets will be 20%.

Dividends:	Institution is prohibited from paying common stock dividends, in excess of $.01 per share per quarter, for 3 years without UST/FDIC/FRB consent. A factor taken into account for consideration of the USG's consent is the ability to complete a common stock offering of appropriate size.
Executive Compensation:	An executive compensation plan, including bonuses, that rewards long-term performance and profitability, with appropriate limitations, must be submitted to, and approved by, the USG
Corporate Governance:	Other matters as specified

Preferred Securities

Issuer:	Citigroup ("Citi")
Initial Holder:	United States Department of the Treasury ("UST").
Size:	$20 billion
Security:	Preferred, liquidation preference $1,000 per share. (Depending upon the available authorized preferred shares, the UST may agree to purchase preferred with a higher liquidation preference per share, in which case the UST may require Citi to appoint a depositary to hold the Preferred and issue depositary receipts.)
Ranking:	Same terms as preferred issued in CPP.
Term:	Perpetual life.
Dividend:	The Preferred will pay cumulative dividends at a rate of 8% per annum. Dividends will be payable quarterly in arrears on February 15, May 15, August 15 and November 15 of each year.
Redemption:	In stock or cash, as mutually agreed between UST and Citi. Otherwise, redemption terms of CPP preferred terms apply.
Restrictions on Dividends:	Institution is prohibited from paying common stock dividends, in excess of $.01 per share per quarter, for 3 years without UST consent. A factor taken into account for consideration of the UST's consent is the ability to complete a common stock offering of appropriate size.
Repurchases:	Same terms as preferred issued in CPP.
Voting rights:	The Preferred shall be non-voting, other than class voting rights on (i) any authorization or issuance of shares ranking senior to the Preferred, (ii) any amendment to the rights of Preferred, or (iii) any merger, exchange or similar transaction which would adversely affect the rights of the Preferred. If dividends on the Preferred are not paid in full for six dividend periods, whether or not consecutive, the Preferred will have the right to elect 2 directors. The right to elect directors will end when full dividends have been paid for (i) all prior dividend periods in the case of cumulative Preferred or (ii) four consecutive dividend periods in the case of non-cumulative Preferred.

Transferability: The Preferred will not be subject to any contractual restrictions on transfer.

Executive Compensation: An executive compensation plan, including bonuses, that rewards long-term performance and profitability, with appropriate limitations, must be submitted to, and approved by, the USG.

Summary of Warrant Terms

Warrant: Institution will issue a warrant to UST for an aggregate exercise value of 10% of the total preferred issued to USG (in both transactions) ($2.7 bn).

Exercise Price: The strike price will be equal to $10.61 per share (the 20 day trailing average ending on November 21, 2008). The warrants issued to UST are not subject to reduction based on additional offerings.

Term: Ten years, immediately exercisable, in whole or in part.

DEPARTMENT OF THE TREASURY

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FEDERAL RESERVE BOARD

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CITIGROUP INC.

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FEDERAL DEPOSIT INSURANCE CORP.

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Press Release

Release Date: November 25, 2008

For release at 8:15 a.m. EST

The Federal Reserve Board on Tuesday announced the creation of the Terr Backed Securities Loan Facility (TALF), a facility that will help market partic meet the credit needs of households and small businesses by supporting th of asset-backed securities (ABS) collateralized by student loans, auto loans card loans, and loans guaranteed by the Small Business Administration (SE

Under the TALF, the Federal Reserve Bank of New York (FRBNY) will lend $200 billion on a non-recourse basis to holders of certain AAA-rated ABS ba newly and recently originated consumer and small business loans. The FRI lend an amount equal to the market value of the ABS less a haircut and will secured at all times by the ABS. The U.S. Treasury Department--under the Assets Relief Program (TARP) of the Emergency Economic Stabilization Ac will provide $20 billion of credit protection to the FRBNY in connection with t The attached terms and conditions document describes the basic terms anc operational details of the facility. The terms and conditions are subject to cl based on discussions with market participants in the coming weeks.

New issuance of ABS declined precipitously in September and came to a ha October. At the same time, interest rate spreads on AAA-rated tranches of / soared to levels well outside the range of historical experience, reflecting ur high risk premiums. The ABS markets historically have funded a substantia consumer credit and SBA-guaranteed small business loans. Continued dis these markets could significantly limit the availability of credit to households businesses and thereby contribute to further weakening of U.S. economic a The TALF is designed to increase credit availability and support economic a facilitating renewed issuance of consumer and small business ABS at more interest rate spreads.

TALF Terms and conditions (72 KB PDF)

2008 Monetary Policy Releases

Last update: November 25, 2008

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Term Asset-Backed Securities Loan Facility (TALF) Terms and Conditions[1]

Facility

The TALF will be a Federal Reserve credit facility authorized under section 13(3) of the Federal Reserve Act. The TALF is intended to assist the credit markets in accommodating the credit needs of consumers and small businesses by facilitating the issuance of asset-backed securities (ABS) and improving the market conditions for ABS more generally.

The Federal Reserve Bank of New York (FRBNY) will make up to $200 billion of loans under the TALF. TALF loans will have a one-year term, will be non-recourse to the borrower, and will be fully secured by eligible ABS. The U.S. Treasury Department will provide $20 billion of credit protection to the Federal Reserve in connection with the TALF, as described below.

Eligible Collateral

Eligible collateral will include U.S. dollar-denominated cash (that is, not synthetic) ABS that have a long-term credit rating in the highest investment-grade rating category (for example, AAA) from two or more major nationally recognized statistical rating organizations (NRSROs) and do not have a long-term credit rating of below the highest investment-grade rating category from a major NRSRO.

All or substantially all of the credit exposures underlying eligible ABS must be newly or recently originated exposures to U.S.-domiciled obligors. The underlying credit exposures of eligible ABS initially must be auto loans, student loans, credit card loans, or small business loans guaranteed by the U.S. Small Business Administration. The set of permissible underlying credit exposures of eligible ABS may be expanded later to include commercial mortgage-backed securities, non-Agency residential mortgage-backed securities, or other asset classes. The underlying credit exposures must not include exposures that are themselves cash or synthetic ABS.

Originators of the credit exposures underlying eligible ABS (or, in the case of SBA-guaranteed loans, the ABS sponsor) must have agreed to comply with, or already be subject to, the executive compensation requirements in section 111(b) of the Emergency Economic Stabilization Act of 2008.

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[1] The Federal Reserve reserves the right to review and make adjustments to these terms and conditions – including size of program, pricing, loan maturity, and asset and borrower eligibility requirements – consistent with the policy objectives of the TALF.

Eligible collateral for a particular borrower must not be backed by loans originated by the borrower or by an affiliate of the borrower.

Eligible Borrowers

All U.S. persons that own eligible collateral may participate in the TALF. A U.S. person is a natural person that is a U.S. citizen, a business entity that is organized under the laws of the United States or a political subdivision or territory thereof (including such an entity that has a non-U.S. parent company), or a U.S. branch or agency of a foreign bank.

Transaction Structure

Credit extensions under the TALF will be in the form of non-recourse loans secured by eligible collateral. Substitution of collateral during the term of the loan will not be allowed. TALF loans will have a one-year term, with interest payable monthly. The term of TALF loans may be lengthened later if appropriate. TALF loans will not be subject to mark-to-market or re-margining requirements.

Any remittance of principal or interest on eligible collateral must be used immediately to pay interest due on, or reduce the principal amount of, the TALF loan.

Haircuts

Collateral haircuts will be established by the FRBNY for each class of eligible collateral. Haircuts will be determined based on the price volatility of each class of eligible collateral.

Pricing and Allocation

The FRBNY will offer a fixed amount of loans under the TALF on a monthly basis. TALF loans will be awarded to borrowers each month based on a competitive, sealed bid auction process. Each bid must include a desired amount of credit and an interest rate spread over one-year OIS. The FRBNY will set minimum spreads for each auction.

The FRBNY will reserve the right to reject or declare ineligible any bid, in whole or in part, in its discretion. In this regard, the FRBNY will develop and implement procedures to identify for further scrutiny potentially high-risk ABS that a borrower proposes to pledge to the FRBNY under the TALF.

The FRBNY will assess a non-recourse loan fee at the inception of each loan transaction.

Roles of Primary Dealers and Clearing Banks

Each borrower must use a primary dealer, which will act as agent for the borrower, to access the TALF and must deliver eligible collateral to a clearing bank.

Role of the U.S. Treasury Department

The FRBNY will create an SPV to purchase and manage any assets received by the FRBNY in connection with any TALF loans. The FRBNY will enter into a forward purchase agreement with the SPV under which the SPV will commit, for a fee, to purchase all assets securing a TALF loan that are received by the FRBNY at a price equal to the TALF loan amount plus accrued but unpaid interest. The U.S. Treasury's Troubled Assets Relief Program (TARP) will purchase subordinated debt issued by the SPV to finance the first $20 billion of asset purchases. If more than $20 billion in assets are purchased by the SPV, the FRBNY will lend additional funds to the SPV to finance such additional purchases. The FRBNY's loan to the SPV will be senior to the TARP subordinated loan, with recourse to the SPV, and secured by all the assets of the SPV. All cash flows from SPV assets will be used first to repay principal and interest on the FRBNY senior loan until the loan is repaid in full. Next, cash flows from assets will be used to repay principal and interest on the TARP subordinated loan until the loan is repaid in full. Residual returns from the SPV will be shared between the FRBNY and the U.S. Treasury.

Executive Compensation Requirements

Originators of the credit exposures underlying eligible ABS (or, in the case of SBA-guaranteed loans, the ABS sponsor) must have agreed to comply with, or already be subject to, executive compensation standards consistent with the U.S. Treasury's TARP guidelines applicable to its Capital Purchase Program.

Termination Date

The facility will cease making new loans on December 31, 2009, unless the Board agrees to extend the facility.

Press Release

Release Date: November 25, 2008

For release at 8:15 a.m. EST

The Federal Reserve announced on Tuesday that it will initiate a program to purchase the direct obligations of housing-related government-sponsored enterprises (GSEs)--Fannie Mae, Freddie Mac, and the Federal Home Loan Banks--and mortgage-backed securities (MBS) backed by Fannie Mae, Freddie Mac, and Ginnie Mae. Spreads of rates on GSE debt and on GSE-guaranteed mortgages have widened appreciably of late. This action is being taken to reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally.

Purchases of up to $100 billion in GSE direct obligations under the program will be conducted with the Federal Reserve's primary dealers through a series of competitive auctions and will begin next week. Purchases of up to $500 billion in MBS will be conducted by asset managers selected via a competitive process with a goal of beginning these purchases before year-end. Purchases of both direct obligations and MBS are expected to take place over several quarters. Further information regarding the operational details of this program will be provided after consultation with market participants.

2008 Monetary Policy Releases

Last update: November 25, 2008

TAB F - Other Materials

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Commercial Paper Funding Facility: Frequently Asked Questions

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E-mail a

EXTERNAI

H 4.1 Facto
Reserve Ba

The following is intended to address operational questions about the Commercial Paper Funding Facility (CPFF).

Effective November 5, 2008

Why is the Federal Reserve establishing the CPFF?
The commercial paper market has been under considerable strain in recent weeks as money market mutual funds and other investors, themselves often facing liquidity pressures, have become increasingly reluctant to purchase commercial paper, especially at longer-dated maturities. As a result, an increasingly high percentage of outstanding commercial paper must now be refinanced each day, interest rates on longer-term commercial paper have increased significantly, and the volume of outstanding commercial paper has declined. A large share of outstanding commercial paper is issued or sponsored by financial intermediaries, and their difficulties placing commercial paper have reduced their ability to meet the credit needs of businesses and households.

What is the purpose of the CPFF?
The purpose of the CPFF is to enhance the liquidity of the commercial paper market by increasing the availability of term commercial paper funding to issuers and by providing greater assurance to both issuers and investors that firms will be able to roll over their maturing commercial paper. These steps should contribute to an overall improvement of conditions in credit markets.

How will the CPFF work?
The CPFF will provide a liquidity backstop to U.S. issuers of commercial paper through a special purpose vehicle (SPV) that will purchase eligible three-month unsecured and asset-backed commercial paper from eligible issuers using financing provided by the Federal Reserve Bank of New York. The SPV will hold the commercial paper until maturity and will use the proceeds from maturing commercial paper and other assets of the SPV to repay its loan from the New York Fed.

When will the CPFF become operational?
The CPFF will become operational on October 27, 2008.

What issuers will be eligible to sell commercial paper to the SPV?
Only U.S. issuers of commercial paper, including U.S. issuers with a foreign parent, are eligible to sell commercial paper to the SPV. A U.S. issuer is an entity organized under the laws of the United States or a political subdivision or territory thereof or is a U.S. branch of a foreign bank.

Can an issuer sell commercial paper directly to the SPV?
Issuers may only sell commercial paper to the SPV through the New York Fed's primary dealers.

May investors sell outstanding commercial paper to the SPV?
No. The SPV will only purchase commercial paper from issuers.

May an issuer repurchase outstanding commercial paper from investors and finance that repurchase by selling commercial paper to the SPV through the New York Fed's primary dealers?
Yes.

Are issuers required to register with the CPFF?
Yes, issuers must register with the CPFF in order to sell commercial paper to the SPV. The registration period begins on Monday, October 20, 2008; registration materials, including wire instructions and a registration form, will be available on this date at http://www.newyorkfed.org/markets/cpff.html. The 10 basis point facility fee must be paid upon registration.

Issuers are only required to register once. To access the facility on October 27, 2008, an issuer must register no later than Thursday, October 23, 2008. Thereafter, issuers that have not registered with the CPFF will be required to register two business days in advance of their intended use of the CPFF. Registration is not required by an issuer that does not intend to access the CPFF.

How is "issuer" defined for the purposes of registration in the CPFF?
Each legal entity that issues commercial paper is considered a separate "issuer" within the construct of the CPFF. If a parent company and a subsidiary issue commercial paper separately, they are considered separate issuers for the purposes of the CPFF.

Will there be any limits on the amount of commercial paper that the SPV will purchase from each issuer?
The maximum amount of a single issuer's commercial paper the SPV may own at any time will be the greatest amount of U.S. dollar-denominated commercial paper the issuer had outstanding on any day between January 1 and August 31, 2008[1]. The SPV will not purchase additional commercial paper from an issuer whose total commercial paper outstanding to all investors (including the SPV) equals or exceeds the issuer's limit. For example, the issuer certifies that the maximum amount of commercial paper that it can sell to the SPV is $1 billion. On October 27, 2008, the issuer has $500 million in commercial paper outstanding with investors, maturing on February 18, 2009. On October 28, 2008, it sells $500 million of commercial paper to the SPV, reaching the maximum amount of commercial paper that the issuer can sell to the SPV at that time. In November, the issuer sells $300 million in 6-month commercial paper to investors other than the SPV. On January 26, 2009, when the commercial paper owned by the SPV matures, the SPV will only be able to buy $200 million of commercial paper from this issuer.

How should an issuer with multiple commercial paper programs determine the maximum amount of commercial paper that the SPV may own at any time?
An issuer with multiple commercial paper programs should determine the maximum amount of commercial paper that the SPV may own at any time by summing outstanding CP across all programs each day between January 1, 2008 and August 31, 2008 and identifying the peak daily amount within that timeframe.

Must an issuer include extendable commercial paper when calculating the maximum amount of the issuer's commercial paper that the SPV may own at one time?
Yes.

If an issuer does not intend to sell its maximum allowable amount of commercial paper to the SPV, may it base its facility fee on the amount of commercial paper it intends to sell to the SPV?
No. The fee is based on the maximum amount of an issuer's commercial paper the SPV may own.

How will the New York Fed determine the maximum amount of a single issuer's commercial paper that the SPV may own at one time?
Upon registration with the CPFF, the issuer will be required to certify the maximum amount of U.S. dollar-denominated commercial paper it had outstanding on any day between January 1 and August 31, 2008. The New York Fed retains the right to verify that maximum amount.

What types of commercial paper will be eligible for purchase by the SPV?
The SPV will purchase unsecured and asset-backed commercial paper (ABCP). The commercial paper must be rated at least A-1/P-1/F1 by a major nationally recognized statistical rating organization (NRSRO) and, if rated by multiple major NRSROs, must be rated at least A-1/P-1/F1 by two or more major NRSROs. The commercial paper must be U.S. dollar-denominated and have a three-month maturity.

Does CPFF eligibility include programs in which there are co-issuers?
If one of the co-issuers of commercial paper is a U.S. issuer of commercial paper and the issuer meets all other program terms and conditions, the commercial paper will be considered eligible. However, as with all eligibility requirements, the New York Fed reserves the right to limit or prohibit participation in the CPFF.

May U.S. branches of foreign banking organizations sell commercial paper to the SPV?
Yes, if a U.S. branch of a foreign banking organization had commercial paper outstanding between January 1 and August 30, 2008, it may sell commercial paper to the SPV. The U.S. branch may not sell any commercial paper issued by other parts of the banking organization to the SPV. In addition, in determining the Maximum Face Value in item 2 of the CPFF issuer registration form, the U.S. branch must not include any commercial paper issued by other parts of the organization.

Will the SPV purchase commercial paper with an extendable maturity?
No.

May municipal commercial paper issuers participate in the CPFF?
At this time the CPFF is not open to municipal issuers.

Does participation in the FDIC's Temporary Liquidity Guarantee Program qualify as a satisfactory guarantee for unsecured commercial paper under the terms and conditions of the CPFF?
Yes. Issuers whose commercial paper is covered by the FDIC's Temporary Liquidity Guarantee Program will be considered

guaranteed to the satisfaction of the New York Fed under the terms and conditions of the CPFF. However, during the initial opt-out period (ending on December 5, 2008) of the FDIC's Program, any such issuer that sells commercial paper to the SPV still will be required to pay the 100 basis point unsecured credit surcharge. If the issuer does not opt out of the FDIC's Program at the end of the opt-out period, the issuer will be entitled to a reimbursement of the unsecured credit surcharge.

After the expiration of the opt-out period, issuers who do not opt out of the FDIC's Program will not be subject to the unsecured credit surcharge for commercial paper subsequently sold to the SPV.

At what price will the SPV purchase commercial paper?
The commercial paper purchased by the SPV will be discounted based on a rate equal to a spread over the three-month overnight index swap (OIS) rate on the day of purchase. The SPV will not purchase interest-bearing commercial paper. The spread for unsecured commercial paper will be 100 basis points per annum and the spread for ABCP will be 300 basis points per annum. For unsecured commercial paper, a 100 basis points per annum unsecured credit surcharge must be paid on each trade execution date.

How will an issuer pay the 100 basis point unsecured credit surcharge for unsecured commercial paper?
On each unsecured commercial paper transaction, the issuer will be charged 100 basis points per annum, on the face value of the commercial paper at time of settlement. When distributing the proceeds of the new commercial paper issuance, the SPV will reduce the proceeds due to the issuer by an amount equal to the unsecured credit surcharge on the face value of the commercial paper.

When will the daily lending rates be announced?
The CPFF daily lending rates will be posted on the New York Fed website each day at 8:00 a.m. ET. In addition, the rates will be published on the BLOOMBERG PROFESSIONAL® service on the CPFF page.

By what time will the primary dealers be required to notify New York Fed's asset manager of CPFF transactions?
A primary dealer must notify the asset manager of the amount of commercial paper that the eligible issuers the dealer supports are interested in selling to the SPV no later than 10:30 a.m. ET.

What are the maximum and minimum transaction sizes?
Although there are no system constraints on the maximum transaction size, the maximum transaction size may not exceed the maximum amount of commercial paper the SPV may own at one time. The minimum transaction size accepted over the BLOOMBERG PROFESSIONAL BOOM® platform is $250,000.

What time will an issuer receive payments for commercial paper sold to the SPV?
Consistent with market convention, commercial paper purchased by the SPV will settle in accordance with the standard settlement times established by the Depository Trust Company (DTC). An issuer's issuing and paying agent determines the time that an issuer receives the proceeds from net new issuance.

How will the SPV be funded?
The SPV will be funded by loans provided by the New York Fed at the target federal funds rate. All credit extended to the SPV will be with full recourse to the SPV and secured by all the assets of the

SPV.

Who will be the asset manager for the SPV?
PIMCO will serve as asset manager and State Street Bank and Trust Company will serve as custodian and administrator, subject to reaching final agreement on terms that are mutually acceptable.

Over what time period will the SPV operate?
The SPV will begin purchasing commercial paper on October 27, 2008, and will cease purchasing commercial paper on April 30, 2009, unless the Board of Governors of the Federal Reserve System extends the CPFF. The New York Fed will continue to fund the SPV after such date until the SPV's underlying assets mature.

What is the legal basis for the CPFF?
The CPFF is authorized under Section 13(3) of the Federal Reserve Act, which permits the Board, in unusual and exigent circumstances, to authorize Reserve Banks to extend credit to individuals, partnerships, and corporations that are unable to obtain adequate credit accommodations.

In what way is the U.S. Treasury supporting the CPFF?
The U.S. Treasury believes this facility is necessary to prevent substantial disruptions to the financial markets and the economy and will make a special deposit at the New York Fed in support of this facility.

How will the Federal Reserve report lending under the CPFF?
The Federal Reserve will not publicly disclose the individual issuers or the amounts provided to individual issuers by the CPFF. Balance sheet items related to the SPV and CPFF will be reported on the H.4.1 weekly statistical release titled "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks." There will be an explanatory cover note on the release when the items are added.

Where should questions regarding the CPFF be directed?
Questions should be directed to the New York Fed's Public Affairs department: 212-720-6130.

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[1] An issuer may not substitute a lower amount, such as a current authorized lending amount, for the maximum amount of commercial paper that the SPV may own.

FAQs: October 27, 2008 ››

TAB F - Other Materials

CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

A CBO STUDY

AUGUST 2004

Estimating the Value of Subsidies for Federal Loans and Loan Guarantees

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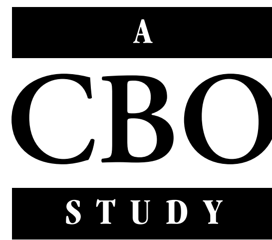
TAB F - Other Materials



Estimating the Value of Subsidies for Federal Loans and Loan Guarantees

August 2004

The Congress of the United States ■ Congressional Budget Office

TAB F - Other Materials

Preface

The Federal Credit Reform Act of 1990 (FCRA) changed the budgetary accounting for federal direct and guaranteed loans from a cash basis to an accrual basis. That shift requires that the government's expected losses from such loans—because of defaults and interest rate subsidies—be recognized in the budget when the credit is extended. The FCRA specifies that uncertain future cash flows associated with such loans be converted (discounted) to their present values using the interest rates on Treasury securities.

With credit-reform rules having been in effect for more than a decade, the Chairman of the House Budget Committee has asked the Congressional Budget Office (CBO) to reexamine the provisions of the FCRA with an eye toward identifying possible improvements in, and extensions of, that accrual basis of budgetary accounting. This study—which is one part of CBO's response to that request—focuses on using commercial interest rates, which incorporate risk, instead of risk-free Treasury rates to measure the cost of federal credit programs.

Deborah Lucas, Marvin Phaup, and Ravi Prasad prepared this report under the direction of Roger Hitchner of CBO's Microeconomic and Financial Studies Division. (Ravi Prasad, now with Bank of America Securities, contributed to this study while serving as a consultant to CBO.) Kim Cawley, Paul Cullinan, Robert Dennis, Peter Fontaine, Kathy Gramp, Arlene Holen, Albert Metz, Elizabeth Robinson, Robert Sunshine, David Torregrosa, Eric Wang, and Thomas Woodward of CBO contributed helpful comments on earlier drafts, and Wendy Kiska provided technical assistance. Susan Woodward of Sand Hill Econometrics and Michael Falkenheim, Robert Kilpatrick, and Sangkyun Park of the Office of Management and Budget reviewed earlier versions of this report; Robert McDonald of Northwestern University offered technical advice. (The assistance of such external participants implies no responsibility for the final product, which rests solely with CBO.)

Christian Spoor edited the study, and John Skeen proofread it. Maureen Costantino produced the cover and prepared the report for publication. Lenny Skutnik printed the initial copies, and Annette Kalicki prepared the electronic versions for CBO's Web site (www.cbo.gov).

Douglas Holtz-Eakin
Director

August 2004

TAB F - Other Materials

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Estimating the Value of Subsidies for Federal Loans and Loan Guarantees

Introduction and Summary

To achieve some of its policy goals, the federal government reduces the price and increases the availability of credit for particular uses by guaranteeing private loans or making loans directly. In fiscal year 2003, the government guaranteed $365 billion in new loans. More than two-thirds of them were for home mortgages, although the government also provides loan guarantees to companies in specific sectors, such as the airline, steel, oil, gas, and rural television industries. In addition, the government extended $36 billion in direct loans in 2003, many of them through its student loan programs. In all, the federal direct and guaranteed loans that were outstanding last year had a total value of $1.4 trillion—nearly two-thirds more than the value 10 years earlier (see Summary Figure 1).[1]

Those credit activities convey subsidies to borrowers—in the form of more-attractive loan terms than borrowers might otherwise obtain—at a cost to the government. The way that cost is treated in the federal budget has changed over time, most significantly in 1990 with the enactment of the Federal Credit Reform Act (FCRA). That legislation redefined the budgetary cost of federal credit activity: instead of the annual cash flow on all outstanding federal loans and loan guarantees, the budget now records the present value of future cash flows on credit extended in the current budget year. In making that change, the FCRA effectively put the accounting of federal credit on an accrual basis (as is the case for interest on federal debt held by the public and some pension costs for federal employees).[2]

The government's estimates of its subsidy costs for loans and loan guarantees are modest, especially in relation to the volume of those loans. For example, the $36 billion in new direct loans obligated in 2003 are estimated to cost the government $657 million over the life of the loans—or $1.83 for each $100 lent (a subsidy rate of 1.83 percent).[3] Similarly, the $365 billion in new guarantee commitments made in 2003 are estimated to cost $4.2 billion—or $1.15 per $100 guaranteed (a subsidy rate of 1.15 percent). Some federal credit programs, such as direct student loans and the Federal Housing Administration's mortgage insurance, appear to make money for the government.

Although the government and private lenders estimate the value of loans and loan guarantees in essentially the same way, two exceptions make government credit programs seem less costly than comparable credit extended by private financial institutions. First, federal agencies' administrative expenses are not included in estimates of subsidy costs (though they appear elsewhere in the federal budget). Second, those estimates exclude the cost of market risk—the compensation that investors require for the

1. For more details about the volume and cost of federal credit programs, see Appendix A.

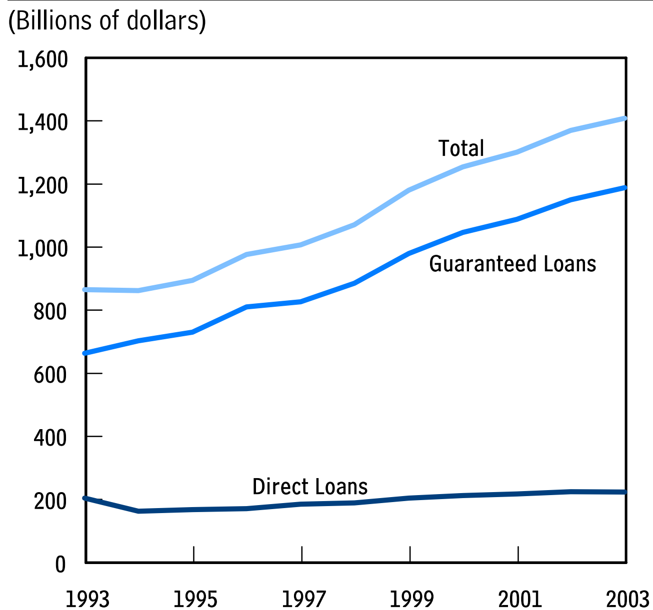
2. See the Federal Credit Reform Act of 1990, included as title XIII, section 13201 of the Omnibus Budget Reconciliation Act of 1990; 2 U.S.C. 661, 104 Stat. 1388-610. See also Congressional Budget Office, *Estimating the Costs of One-Sided Bets: How CBO Analyzes Proposals with Asymmetric Uncertainties* (October 1999); Office of Management and Budget, "Federal Credit," part 5 of *Preparation, Submission, and Execution of the Budget*, Circular No. A-11 (July 2004), available at www.whitehouse.gov/omb/circulars/a11/current_year/s185.pdf; and Marvin Phaup, "Credit Reform, Negative Subsidies, and FHA," *Public Budgeting & Finance*, vol. 16, no. 1 (1996), pp. 23-36.

3. *Budget of the United States Government, Fiscal Year 2005: Analytical Perspectives*, Tables 7-3 and 7-4.

Summary Figure 1.

Federal Credit Outstanding, 1993 to 2003

(Billions of dollars)



Source: Congressional Budget Office based on data from the Office of Management and Budget.

uncertainty of expected but risky cash flows. The reason is that the FCRA requires analysts to calculate present values by discounting expected cash flows at the interest rate on risk-free Treasury securities (the rate at which the government borrows money).[4] In contrast, private financial institutions use risk-adjusted discount rates to calculate present values.

Despite those limitations, credit-reform accounting provides more-useful cost estimates than did the cash-basis accounting it replaced. The current approach is forward-looking for the life of a loan; it accounts for the time value of money; and it generally assigns the same budgetary cost to equivalent loans and loan guarantees.

The FCRA adopted the private market's definition of value (the present value of expected cash flows, with the two exceptions noted above) in an attempt to "place the cost of credit programs on a budgetary basis equivalent to other federal spending . . . and improve the allocation of resources among credit programs and between credit and other spending programs."[5] The costs of other programs in the federal budget are based on market prices—such as the estimated price of buying a weapon, repairing a road, or furnishing a service. In the case of credit programs, however, omitting some of the costs of providing credit results in an overstatement of the value of the government's loans and guarantees. One indication of that overstatement is that proposed sales of federal loans to private investors usually appear to result in losses to the government because the market value of a loan is almost always less than the credit-reform value. The primary reason is the difference in discount rates used by the market and under credit reform.

Following more than a decade of experience with credit reform and rapid advances in financial theory and practice, this Congressional Budget Office (CBO) study reexamines the use of risk-free Treasury rates to value federal loans and guarantees and to estimate their subsidy costs.[6] It discusses two approximately equivalent modifications to the current approach, both of which would use market prices: risk-adjusted discounting and options pricing. The analysis then employs options pricing to show how that method's estimates of federal subsidy costs differ from Treasury-rate estimates for two major government loan guarantees—those made to Chrysler in 1980 and America West Airlines (AWA) in 2002.

Those two loan guarantees were riskier than the ones typically made under government credit programs. Thus, the difference between market-value estimates of their costs and Treasury-rate estimates would be expected to be greater than for many other programs. Nevertheless, for all programs, ignoring the cost of risk understates the federal cost of credit assistance, potentially biasing the allocation of budgetary resources. For example, excluding the

4. Calculations of present value (a single number that expresses a flow of current and future payments in terms of an equivalent lump sum paid today) depend on the particular interest rate used. For example, if $100 is invested on January 1 at an annual interest rate of 5 percent, it will grow to $105 by January 1 of the next year. Hence, under the assumption of a 5 percent annual interest rate (or discount rate), the present value of $105 payable a year from today would be $100.

5. 2 U.S.C. 661.

6. Although Treasury securities are free from the risk of default, they are subject to other risks, including price risk (the risk that changes in market interest rates or other factors will alter the value of the securities). That risk is reflected in the market prices and yields on Treasury debt. In this study, the term "risk- free Treasury rates" refers only to the default-free quality of those securities.

cost of risk from budget and program decisions may mislead policymakers by suggesting that some federal credit programs provide financial resources to the government at no cost to taxpayers. It also encourages reliance on credit rather than other policies that might be more efficient in achieving particular goals.

The principal conclusions of this study are these:

- Market risk is a cost to the government.

- With the exception of administrative costs, projected cash flows on federal loans and loan guarantees are identical under credit-reform and market valuation. The key difference between the two methods is the use of different discount rates.

- Using Treasury rates to discount expected cash flows neglects the cost of market risk and results in the systematic understatement of costs for both direct and guaranteed loans. Using risk-adjusted discount rates, which include the cost of market risk, would correct that understatement and improve the comparability of budgetary costs for credit and other programs.

- For some federal loans and guarantees, risk adjustment can have a significant effect on cost estimates. For instance, when the market price of risk is taken into account, the subsidy rate on the Chrysler loan guarantee is 15.9 percent rather than 7.2 percent, CBO estimates, and the subsidy rate on the America West guarantee is 6.9 percent instead of -12.7 percent. For other programs with less exposure to market risk, the effect on subsidy estimates may be much smaller. (Producing estimates for other programs was beyond the scope of this analysis.)

- Which market-pricing method is appropriate to use for a federal credit program depends on the characteristics of the program and of borrowers. This study uses an options-pricing approach to estimate the value of the Chrysler and AWA loan guarantees. That method is well suited to valuing federal loans and guarantees to private companies. For other programs, such as those providing student loans and home mortgage guarantees, alternative approaches to adjusting discount rates for risk are likely to be easier to apply.

Costs Under the FCRA and with Market Prices

To calculate lifetime costs for new direct and guaranteed loans in a budget year, analysts project the government's expected cash flows for loan disbursements, defaults, interest payments, fees, and repayments for the expected lives of the loans. Those future dollars are converted to present values through discounting to take account of the time value of money (the fact that a dollar tomorrow is worth less than a dollar today because of the interest that could have been earned on that dollar in the meantime). The credit-reform subsidy is the estimated difference between the present value of expected cash outflows and expected cash inflows at the time the credit is extended. As the financial condition of borrowers changes over time, the value of a loan or guarantee also changes. Periodic budget reestimates allow those changes to be recognized in the budget over the life of the loan.

The FCRA mandates that future cash flows be discounted using interest rates on marketable Treasury securities with similar maturities to the loans in question. In the case of risk-free loans (those whose cash flows are certain and do not change with the state of the economy), that method results in an estimate of the market value of the loans, just as it does for a promise of payment by the Treasury.[7] In the case of risky loans (those whose expected cash flows are uncertain), that procedure systematically overestimates the market value of promised cash flows by discounting at too low a rate. Equivalently, it underestimates the cost of loan guarantees—that is, the value of cash shortfalls that the government has to make up when an underlying loan defaults.

Market prices, by contrast, reflect the fact that risky future cash flows are discounted by investors at risk-adjusted rates. For loans, higher market risk implies a higher discount rate and a lower present value of expected cash flows. Since the value of a loan guarantee is the difference between the value of the loan's principal and the present value of expected repayments, higher market risk implies a higher value for the guarantee. Private financial institutions use a variety of methods to estimate the mar-

7. In other words, if the Treasury promises with certainty to pay $106 one year from now (backed by the government's sovereign power to tax and to print money), and the market rate on Treasury securities is 6 percent, then the present value of the promise is $100. That result can be confirmed by observing that such a promise will have a current market price of $100.

ket value of loans and loan guarantees. Some of those approaches could be adapted to valuing federal credit. This study focuses primarily on one widely used method, options pricing, although it also discusses an alternative, risk-adjusted discount rates.

The Relevance of Market Prices and Market Risk to Government Budgeting for Credit Programs

The main rationales for using market prices to estimate the cost of federal credit assistance are that such prices provide a comprehensive measure of cost, are consistent with the measurement of other programs' costs, and offer the best available way to gauge the opportunity costs to society from such credit assistance.[8] If the government provides goods or services at a below-market price, it incurs an opportunity cost on behalf of its stakeholders (taxpayers and beneficiaries of government programs) in the amount of the underpricing. When the government assumes credit risk, that risk is passed on to government stakeholders, and its value represents a cost. With the exception of a few differences described below, the government is like any financial institution that assumes costly risks on behalf of others. Thus, assumed risks are as relevant to the government as to other financial intermediaries and constitute a cost to its stakeholders. Relying on market prices offers a straightforward way to measure that cost and one that is consistent with other budgetary practices.[9]

Market risk arises from the volatility of the economy and from associated changes in the value of aggregate wealth. Because those changes create undesired uncertainty, they are costly to investors and are reflected in market prices. Market risk differs from diversifiable risk, which can effectively be eliminated by pooling it—in the case of financial assets, for example, by diversifying a portfolio so that unexpected gains on some investments offset unexpected losses on others. Market risk, by contrast, is associated with economywide increases or decreases in asset values, so it cannot be eliminated through portfolio diversification.[10]

Is Market Risk Relevant?

Some observers have argued that market risk is not a cost to the government and that Treasury rates are appropriate for valuing government cash flows, even if those flows are risky. Two main justifications are sometimes offered for that view: first, that the government can borrow at Treasury rates, so its costs are lower than those of other financial institutions; and second, that the government can spread financial risk more widely than other institutions can, effectively making the risk diversifiable and thus without cost to stakeholders.

The first argument—that the government can borrow at a risk-free rate—ignores the role of stakeholders in enhancing the government's credit quality. The Treasury can borrow at a relatively low rate (by creating nominally safe securities) in part because of its sovereign power to tax. However, the authority to draw on the resources of others to ensure repayment of debt obligations does not reduce the risk that the government assumes by extending risky loans and guarantees. Rather, it is the means by which such risk is shifted to taxpayers and beneficiaries of government programs, who are, in essence, equity holders in the government's financial activities.

For example, suppose the government borrows $1,000 through the sale of Treasury securities and makes a risky loan for $1,000. In balance-sheet terms, the government has acquired a risky asset that will pay $1,000 at most and a risk-free liability of $1,000. That transaction adversely affects stakeholders because they now bear more financial risk than before the loan was made: they are liable for repayment of the government securities, independent of the performance of the loan. If the loan returns only $900, stakeholders lose $100. In fact, financing a loan with a debt issue implies that stakeholders have the equivalent of a highly leveraged, and hence very risky, ownership position in the loan. The critical implication of that example is that the government's ability to create a risk-

8. Opportunity cost is the highest value of resources in alternative uses. Putting resources into one activity prevents their use in other activities. The highest value of a forgone alternative is the opportunity cost of the chosen activity.

9. David F. Bradford, "On the Uses of Benefit-Cost Reasoning in Choosing Policy Toward Global Climate Change," in Paul R. Portney and John P. Weyant, eds., *Discounting and Intergenerational Equity* (Washington, D.C.: Resources for the Future, 1999), pp. 37-43. See also the statement of Douglas Holtz-Eakin, Director, Congressional Budget Office, "The Economic Costs of Long-Term Federal Obligations," before the House Committee on the Budget, July 24, 2003.

10. Thomas E. Copeland and J. Fred Weston, *Financial Theory and Corporate Policy*, 3rd ed. (New York: Addison-Wesley, 1992), Chapter 6.

free liability results from its sovereign authority to draw on the people's resources. That authority does not protect stakeholders from market risk, nor does it increase the value of a loan above its market value.

The second argument—that the cost of risk is lower to the government because it can spread the risk more widely—is relevant to diversifiable risk but not to market risk. It is sometimes argued that the government can spread losses more widely over the population than, say, insurance companies can by compelling participation in the risk pool. However, as noted above, market risk cannot be eliminated by diversification because it results from an aggregate change in asset values. Even if the government eliminated the diversifiable risk inherent in its lending activities, the associated market risk would remain. At best, a government guarantee could shift the market risk from one group (lenders) to another (taxpayers and other government stakeholders).

A related argument is that the government's ability to borrow and repay that borrowing with future taxes allows it to reduce market risk by spreading the risk among generations. However, borrowing does not increase total resources; rather, it redistributes existing resources from lenders to borrowers. Moreover, risk is not reduced by the government's power to print money, because financing credit losses by creating money substitutes an inflation tax for a pecuniary tax. In the end, someone must bear the consequences of unpredictable financial returns, and markets determine a price for assuming that risk.

Differences Between the Government and Private Financial Institutions

Although the government does not have a capacity to bear risk on its own, it may have some advantages over private institutions that reduce its relative borrowing costs. The Treasury benefits from economies of scale in issuing, placing, and servicing debt, which lowers its transaction costs. The high liquidity of Treasury debt also reduces federal borrowing costs. But liquidity does not represent true savings if it comes at a cost to stakeholders through the backstop they provide against losses. In addition, the fact that Treasury securities are exempt from state and local taxes reduces the yield that investors require on them relative to the yield on private borrowing. However, lower state and local tax collections do not represent an economic gain to citizens, who have to pay more of those taxes to support services because states and localities cannot tax Treasury securities.

More fundamentally, none of those advantages are relevant from the perspective that the appropriate measure of the government's cost of providing credit is its opportunity cost. That cost is the least expensive alternative for accomplishing a goal—in other words, the cost of credit provided by private lenders.

The question of the appropriate discount rate for the government dates back at least to the classic 1970 paper of Kenneth Arrow and Robert Lind, which formalized the argument that when all risks are diversifiable, the government's cost for bearing those risks is minimal.[11] Although that paper is widely cited to justify the use of risk-free rates to discount federal cash flows, its conclusions do not apply to situations with market risk. Later authors, such as Robert Merton, distinguish between diversifiable and market risk and include the market price of the latter in their analyses of federal financial programs that have significant exposure to market risk (such as programs that provide deposit and pension insurance).[12]

The issue of discount rates also arises in accounting for federal investments in private securities. Without recognition of the cost of market risk, the budget will give the appearance that the government can finance itself by borrowing at the risk-free rate and investing in a portfolio of risky private securities with an expected return higher than that rate.[13]

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11. Kenneth J. Arrow and Robert C. Lind, "Uncertainty and the Evaluation of Public Investment Decisions," *American Economic Review*, vol. 60, no. 3 (1970), pp. 364-378.

12. Robert C. Merton, "An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees: An Application of Modern Option Pricing Theory," *Journal of Banking and Finance*, vol. I, no. 1 (June 1977), pp. 3-11; and Merton, "Applications of Option-Pricing Theory: Twenty-Five Years Later," *American Economic Review*, vol. 88, no. 1 (March 1988), pp. 323-349. For a more recent discussion, see Steven Boyce and Richard A. Ippolito, "The Cost of Pension Insurance," *Journal of Risk and Insurance,* vol. 69, no. 2 (2002), pp. 121-170.

13. For a parallel discussion of the budgetary treatment of federal investments in equity securities, see *Budget of the United States Government, Fiscal Year 2004: Analytical Perspectives*, "Railroad Retirement Board Investments," p. 471; and Congressional Budget Office, *Evaluating and Accounting for Federal Investment in Corporate Stocks and Other Private Securities* (January 2003).

Methods for Valuing Federal Loans and Guarantees

For both Treasury-rate and market-value estimates, the subsidy cost is the difference between the value of what the government gives and what it receives in a transaction. In the case of a direct loan, the government gives cash now and receives a promise of repayments of principal, interest, and fees in the future. In the case of a loan guarantee, the government commits to pay off the lender if the borrower defaults. For that commitment, the government often receives fees paid by the borrower. When the borrower is a publicly traded corporation, the government sometimes also receives compensation in the form of warrants to purchase stock. (A warrant is a type of call option that gives the government the right to buy shares of the company's stock in the future for a predetermined price.) To calculate the net cost of such a loan guarantee, it is necessary to value all of the components of the agreement: the guarantee itself, the fees, and the warrants. This section explains various methods for determining that value, and the next section applies some of those methods to the guarantees, fees, and warrants in two large federal credit deals.

The Treasury-Rate Approach

Under current practice, the first step in estimating subsidy costs for a direct or guaranteed loan is to project the government's expected cash inflows and outflows from the transaction. Projected cash flows include the disbursement of principal, expected repayments, and fees. Expected values for the government's cash receipts depend on the probability of default each year, the recovery rate on defaulted loans, the planned repayment (amortization) schedule of a loan, estimated voluntary prepayments, and the fee schedule. As required by the FCRA, projected future cash flows are discounted at Treasury rates to obtain the present value of the direct loan or guarantee.

A few simple examples illustrate the process. First, suppose a federal agency makes a direct loan of $100 for one year at the government's borrowing rate of 5 percent. If the loan is free of credit risk, the agency is certain of being repaid $105 in principal and interest at the end of the year. Under credit reform, the value to the government of that loan at its origination is the discounted present value of $105 in one year. Using the government's borrowing rate of 5 percent as the discount rate, the loan value (V) is:

1) $V = \$105/1.05$
$= \$100$

Because the loan is repaid in full with interest, the present value of the future repayment ($100) is equal to the amount advanced ($100), so the cost of the loan to the government is zero.

Second, suppose the agency makes a loan for the same amount on the same terms but with some credit risk involved. On the basis of experience, the agency projects that 25 percent of loans like this one will default at the end of a year. In such defaults, the government expects to recover only $30 from the borrower. Under the current approach, the value of this loan to the government is the present value of the weighted average expected return, with the weights being the probability of default and repayment in full, respectively.[14] That is:

2) $V = 0.25\ (\$30/1.05) + 0.75\ (\$105/1.05)$
$= 0.25\ (\$28.57) + 0.75\ (\$100)$
$= \$82.14$

In that case, the government has given greater value ($100) than it expects to receive, on average, in return ($82.14). The cost (C) of the direct loan is the difference between value given and received. That is:

3) $C = -\$100 + [0.25\ (\$28.57) + 0.75\ (\$100)]$
$= -\$17.86$

Third, suppose that instead of making a direct loan, the agency simply guarantees that a private lender making the loan to the same borrower on the same terms will be paid in full if the borrower defaults. As guarantor, the government will have to pay off the lender 25 percent of the time, in each such case giving the lender $105 in principal and interest and collecting $30 from the borrower. The government's cost will be the discounted present value of those net payments (given that 75 percent of the time the government will pay nothing). That is:

4) $C = 0.25\ [(-\$105/1.05) + (\$30/1.05)] + 0.75\ (\$0)$
$= 0.25\ [-\$100 + 28.57] + 0$
$= -\$17.86$

14. See Congressional Budget Office, *Estimating the Costs of One-Sided Bets*.

which is the same as the cost to the government of the direct loan in the previous example. That result illustrates the general principle that the cost of a direct loan is the same as the cost of a guarantee made on the same terms with the same risks. In both cases, the budgetary cost is the present value of expected losses.

Although those examples are illustrative, they oversimplify the analytical difficulty of accurately projecting future cash flows from federal credit activity. Most federal direct and guaranteed loans have a longer maturity than one year, so defaults and recoveries are spread over a longer period. Moreover, the probability of default and the amount expected to be recovered are likely to vary with many things, including the length of time since origination.

More important, defaults do not occur randomly. They result from economic decisions and factors that can be used to project cash flows more accurately. For example, borrowers rarely default on loans when the value of the asset used as collateral exceeds the amount of the unpaid loan balance. Instead, they can sell the asset, pay off the loan, and keep the difference. To predict defaults and the associated cash flows on some loans, therefore, budget analysts could project the expected evolution of the price of the borrower's assets along with the unpaid balance of the loan. As the price of a collateral asset falls, the probability of default increases. Thus, the probability of default at each point in time can be determined from the probability distribution of asset prices. And those distributions can be projected into the future on the basis of the starting price of the asset, its volatility, and its expected rate of return.

Prepayments—which are permitted without penalty for most federal credit programs—also affect the expected cash flows to the government from direct loans and guarantees. Prepayments extinguish the risk of default and terminate the collection of fees. Like defaults, prepayments are usually economically motivated and can be predicted from rising asset values and other factors associated with attractive refinancing opportunities, such as declining interest rates. Successfully projecting those factors can significantly improve the accuracy of estimates of cash flows to the government.

In practice, time and resource limitations often preclude such detailed modeling of projected cash flows for subsidy estimates. Budget analysts have a variety of simpler methods available for assessing the government's exposure to the risk of default or prepayment—including, for example, the use of historical default rates for loans with specific credit ratings. However, focusing on the future evolution of the value of the borrower's assets is consistent with the rules of credit reform and is a straightforward means of getting at the economic motive for default. It is also the method that most closely parallels modern private-sector methods for estimating the value of credit guarantees. CBO is currently exploring the usefulness of those methods to budget analysts, both for improving the accuracy of cash flow projections and for providing additional information about the cost of risk.

Risk-Adjusted Discount Rates and Options-Pricing Methods

As with Treasury-rate estimates, producing market-value estimates of subsidy costs also requires estimating the probability distribution of cash flows over the life of a loan or guarantee. The key difference is that the rates used to discount projected cash flows reflect the market price of risk. The financial sector commonly uses several methods to incorporate the price of market risk into estimates of value. For securities that are actively traded, the simplest and most reliable approach is to rely on observed market prices. For loans and guarantees for which market prices are unavailable or unreliable, one alternative is to use an adjusted-discount-rate (ADR) method. Another is to apply options-pricing methods.

Adjusted Discount Rates. The ADR method adds a spread—the difference between the interest rate on a Treasury security and the rate on a risky security—to Treasury rates and uses the resulting adjusted rate to discount expected cash flows associated with a loan. That higher rate results in a smaller present value of expected future payments, reflecting the cost of market risk. As before, the subsidy cost of a loan or loan guarantee is the extent to which the present value of expected payments falls short of the loan principal. The procedure is the same for both loans and loan guarantees because, in either case, the loss to the government reflects the shortfall in expected repayment value.

To illustrate, consider the previous example of a $100 one-year loan with a 25 percent chance of default and an expected recovery of $30 in the case of default. If the risk-adjusted discount rate is 7 percent instead of the risk-free rate of 5 percent used in equation 2, the estimated market value of the loan will be:

5) V = 0.25 ($30/1.07) + 0.75 ($105/1.07)
= 0.25 ($28.04) + 0.75 ($98.13)
= $80.61

That value is $1.53 less than the estimated value with risk-free discounting; thus, the subsidy cost of the loan is higher by the same amount—$19.39 instead of $17.86. As is always the case, the value of a guarantee on that loan is identical to the subsidy on the loan, because the guarantor (the government) makes up for the difference between the principal of the loan and the value of what is repaid, which is the $19.39 subsidy cost.

One difficulty in applying the ADR method to a loan or guarantee is that the implicit market risk—and hence the appropriate discount rate—can vary significantly over the life of the loan.[15] Another issue is that spreads between Treasury rates and private lending rates are influenced by a variety of factors other than market risk, such as differential tax treatment, transaction costs, and liquidity.[16] Some or all of those other factors could be considered legitimate elements of the opportunity cost to the government of making or guaranteeing loans since they affect people's willingness to pay for those credit services. If such factors were considered significant, adjustments would be necessary to reflect only that part of the rate spread attributable to market risk.

Options Pricing. The general idea behind options-pricing methods is that assets with the same payoffs must have the same price; otherwise, investors would have the opportunity to earn a risk-free profit by buying low and selling high. The options-pricing method that CBO used for this analysis—the binomial pricing model—exploits that "no arbitrage" assumption by inferring the value of an option (in this case, a loan guarantee) from the price of a portfolio of assets that has the same payoff to the government as the guarantee.[17] (For an explanation of why a loan guarantee can be considered an option, see Box 1 on page 11.) A highly useful feature of that approach is that the payoff from a loan guarantee can be approximately replicated using a portfolio made up of risk-free bonds and assets of the borrowing firm, all of whose prices can be estimated.

In principle, both options pricing and risk-adjusted discount rates should yield identical subsidy estimates. As a practical matter, they entail different types of approximations. Because options-pricing methods account for the changing risk of loan guarantees over time, they are likely to be more accurate at estimating the market value of subsidies—but only when the necessary data and models are available. Otherwise, they may be difficult or cumbersome to apply.

The practices of private financial institutions offer some guidance about which method is likely to prove the most accurate and feasible in particular cases. Options-pricing methods are often used for estimating the value of credit guarantees to businesses, which suggests that they are most suitable for credit to commercial enterprises. In those cases, the fact that things other than market risk can affect interest rate spreads is less relevant, because the value of the reference assets used for pricing (generally, publicly traded stocks) are less sensitive to those nonrisk factors. Private financial institutions also rely on options-pricing methods to value the option to prepay residential mortgages. Hence, those methods may be applicable to the many government mortgage programs that include a prepayment option. In addition, analysts have used options-pricing methods to value deposit insurance.[18]

Options-based methods are rarely used, however, to value loans or loan guarantees extended to individuals because of the difficulty of estimating the required variables, such as expected rates of return on borrowers' assets. For federal loans or guarantees made to individuals (such as student loans), a more standard approach would be to use

15. For example, many firms use the capital asset pricing model (CAPM) to adjust discount rates for risk when valuing capital investments. For a loan guarantee, the correct CAPM rate and thus the value of the guarantee change with time and with the assets and liabilities of the borrower and so are difficult to estimate.

16. See, for example, R. Glenn Hubbard, *Money, the Financial System, and the Economy* (New York: Addison-Wesley, 1994), pp. 143-155.

17. Appendix B provides an example of how the binomial pricing model might be used to estimate the value of a loan guarantee. For more information about such models, see Robert L. McDonald, *Derivatives Markets* (New York: Addison-Wesley, 2003), Chapter 10.

18. Alan Marcus and Israel Shaked, "The Valuation of FDIC Deposit Insurance Using Option-Pricing Estimates," *Journal of Money, Credit, and Banking* (November 1984), pp. 446-460; and Ehud Ronn and Avinash Verma, "Pricing Risk-Adjusted Deposit Insurance: An Option-Based Model," *Journal of Finance* (September 1986), pp. 871-895.

private-sector rates of return on consumer credit of similar quality to identify a risk-adjusted discount rate.[19] That rate would be used to discount expected net cash flows and thus to calculate the difference between those flows and the loan principal.

Other federal credit programs—such as loan assistance to sovereign states, municipalities, and special-purpose enterprises—do not fit directly into either the commercial or consumer categories. Estimating the cost of such programs is difficult even under current budgetary rules because there often is little or no experience with a similar transaction on which to draw. In some of those cases, an options-pricing approach is likely to be feasible; in others, using the ADR method will be preferable.

Estimating the Subsidies to Chrysler and America West Airlines

As noted in Box 1, options pricing is an especially useful type of risk adjustment for valuing complex loan guarantees extended to firms. Accordingly, this analysis illustrates the effect of risk adjustment on federal credit-subsidy estimates by applying options pricing to the federal guarantees extended to Chrysler and America West Airlines in 1980 and 2002, respectively—two instances of complicated guarantee transactions between the government and severely distressed companies. For comparison, this analysis also estimates the value of those guarantees using the Treasury-rate approach.

The government's cost of extending a loan guarantee—whether estimated using Treasury-rate or market-based methods—depends on the present and future financial condition of the borrower and the terms of the guarantee. With both the Chrysler and AWA guarantees, the financial outlook for the firms was highly uncertain and the guarantee terms were complex. That uncertainty and complexity must be addressed regardless of the estimating method used.

Chrysler's Financial Condition and Guarantee Terms

In the 1970s, rising energy prices and the associated growth in demand for fuel-efficient cars hurt the U.S. auto industry.[20] Chrysler was especially hard hit because of its high costs, weak financial condition, and unfavorable mix of vehicles. By 1979, the company faced a declining market share, a reduced credit rating, and operating losses of more than $1 billion. With its financial survival in doubt, Chrysler asked the federal government for assistance to avoid bankruptcy and possible liquidation.

The Congress held hearings on Chrysler's financial condition in October and November of 1979. Arguments in favor of federal assistance included the temporary nature of Chrysler's difficulties and their external causes: "a series of energy-related external shocks not of the company's making, which are unique to the automobile industry."[21] Advocates of assistance also argued that the direct cost of inaction—more than 500,000 job losses and a $3 billion to $10 billion increase in the federal deficit, they claimed—was greater than the maximum cost to the government. Opponents of federal assistance argued that the projected
social costs of Chrysler's failure were exaggerated, that federal aid would expose the government to large losses, and that the discipline of the private market would be diminished if the government encouraged expectations that it would intervene to save large failing companies. In the end, lawmakers enacted the Chrysler Corporation Loan Guarantee Act in December 1979.

The following spring, in negotiations between Chrysler and the Secretary of Treasury, the government agreed to a loan guarantee of up to $1.5 billion of principal plus accrued interest—contingent on the company's obtaining $1.5 billion in financial assistance and commitments from nongovernmental sources. The government became Chrysler's senior creditor, meaning that it would be first in line to take the company's assets in the event of default. Chrysler also agreed to pay the government an annual guarantee fee of 1.0 percent of the guaranteed amount and to furnish it with warrants for 14.4 million common

19. That rate, which reflects the cost of the capital backing the loans, is generally lower than the quoted borrowing rate, which includes additional compensation for default losses. For an extensive discussion of the cost of capital, see, for example, Richard Brealey and Stewart Myers, *Corporate Finance*, 7th ed. (New York: McGraw Hill, 2003).

20. This Chrysler analysis is based in part on Robert F. Bruner, *Chrysler's Warrants: September 1983,* Case No. UVA-F-0682 (Charlottesville, Va.: University of Virginia, Darden Graduate School of Business Administration, 1991).

21. House Report No. 96-690 to accompany H.R. 5860 and House Conference Report No. 95-730, December 20, 1979.

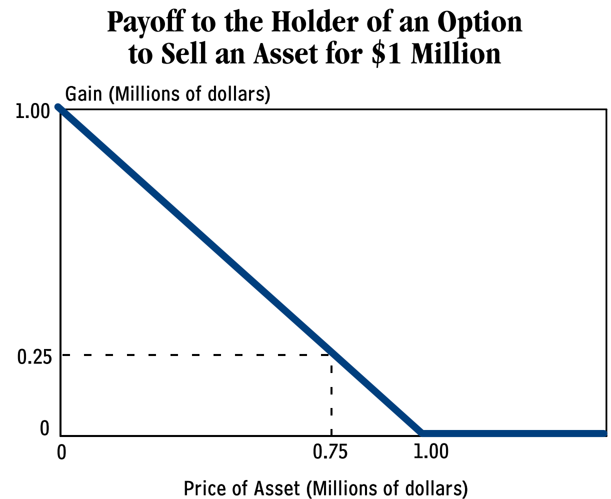
Box 1.

Loan Guarantees as Put Options

In general, options-pricing methods are applicable to loans and loan guarantees because a loan guarantee is a type of "put option"—a contract that gives the holder the right (though not the obligation) to sell specified assets for a predetermined price, no matter how little they turn out to be worth.[1]

Suppose a factory owner obtains a put option to sell the factory for a "strike price" of $1 million during the next three months. If the market value of the factory is greater than $1 million, the owner will not exercise the option because other buyers would be likely to pay more than that strike price. However, if the value of the factory falls below $1 million during the life of the option, the owner will exercise the option and gain the difference between the market value of the asset and the strike price. For instance, as illustrated in the figure to the right, if the price of the factory declines to $750,000, the owner will exercise the option to sell at $1 million and make $250,000. In the extreme, if the value of the factory drops to zero, the owner will collect $1 million from the seller (the writer of the option). The put option thereby insures the factory owner against a decline in asset price.

Payoff to the Holder of an Option to Sell an Asset for $1 Million



Now consider a buyer who purchases the factory at its current market value of $1 million with money obtained from a federally guaranteed loan secured by the factory. Suppose that with a 100 percent federal guarantee, a bank is willing to lend the buyer $1 million to purchase the plant. In that case, the potential

1. This discussion draws on "Options Are Insurance," Chapter 2, Section 5 in Robert L. McDonald, *Derivatives Markets* (New York: Addison-Wesley, 2003).

shares of Chrysler stock. Those warrants gave the government the right to buy Chrysler stock at $13 per share through 1990. (Participating banks were also given warrants on the same terms for nearly 13.3 million shares.)[22] With the guarantees, Chrysler was able to borrow at an average interest rate of 12.12 percent, much lower than the 20 percent rate it had paid before receiving the guarantee.

AWA's Financial Condition and Guarantee Terms

America West Airlines was the eighth largest U.S. passenger airline in 2002, with a fleet of 146 planes serving 59 destinations.[23] Its operations were concentrated around principal hubs in Phoenix and Las Vegas and a minor hub in Columbus, Ohio. In 2001, AWA flew 20 million passengers and generated $2 billion in revenues.

22. Ultimately, Chrysler borrowed just $1.2 billion and issued less than the full number of warrants. It issued $500 million in notes at 10.35 percent in June 1980, another $300 million in July at 11.40 percent, and $400 million in February 1981 at 14.90 percent. The valuations in this analysis are based on the full amount of the initial agreements, since it was not known at the time that less than the full amount would be utilized.

23. America West Holdings Corporation—which trades on the New York Stock Exchange under the symbol AWA—is the parent company of America West Airlines. In 2002, the airline was the only operating subsidiary of America West Holdings, although there is now a second subsidiary (the Leisure Company). This report uses AWA, America West Holdings, and America West Airlines interchangeably.

Box 1.

Continued

payoffs to the borrower from the guarantee would be the same as those shown in the figure for the original owner who held an option to sell the factory. In other words, the guaranteed loan secured by the factory gives the borrower the right to "put" the collateral asset to the government at a price equal to the balance on the loan. Of course, the borrower will exercise that option only if the price of the factory falls below the amount of the loan, or $1 million. Thus, the loan guarantee is insurance against a drop in the value of the factory, which was the source of the loan's credit risk. The loan guarantee shifts the risk of a decline in the price of the collateral asset from the lender to the government.

Thus, the position of a borrower is similar to that of the holder of a put option, whereas the position of the lender or guarantor is akin to that of the writer of the option. That is, the borrower can "sell" (put) the collateral assets to the lender or guarantor at a price equal to the unpaid balance on the loan. In fact, the relationship between the value of collateral assets and of debt is a key factor affecting the likelihood and expected cost of default—just as the value of the underlying assets relative to the strike price is key to the value of a put option. When the value of the assets is substantially above the amount owed, the borrower will refinance or sell the assets and pay off the debt rather than default on the loan obligation. But when the value of the assets is less than the unpaid balance, the borrower no longer has the opportunity to refinance or to liquidate the assets and repay the loan obligation. In that case, default is more likely. If default occurs, the guarantor pays the amount due to the lender, seizes the collateral assets, and takes a loss equal to the difference between the promised loan payments and the residual value of the assets. In the case of a loan to a commercial enterprise, the potential range of losses to the guarantor is equivalent to that for a written put option on the assets of the firm with a strike price equal to the face value of the loan.

The correspondence between put options and loan guarantees—along with the availability of computer programs for calculating option values—makes options pricing a natural choice for estimating risk-adjusted subsidy costs for some federal direct and guaranteed loans. Options-pricing methods are especially useful in valuing complex loan guarantees extended to companies, such as the federal guarantees to Chrysler and America West Airlines that are analyzed in this study.

That year was a difficult one for U.S. airlines, however. Earnings were in decline even before the terrorist attacks of September 11 because of a fall in high-yield business traffic, rising fuel costs, and reduced operating margins. The terrorist attacks dramatically worsened the economic condition of the airline industry, including AWA, whose credit rating was downgraded in a series of steps. Moody's reduced its rating of AWA's senior unsecured debt from B1 in April 2001 to Ca on November 21, 2001. Standard & Poor's similarly lowered AWA's credit rating from B+ on September 18, 2001, to CCC- on November 1, 2001.

In the wake of the September 11 attacks, lawmakers enacted the Air Transportation Safety and System Stabilization Act, which allowed airlines to apply for credit guarantees from the federal government. The credit downgrades described above meant that AWA would have found it expensive—if not impossible—to raise funds in private markets. Accordingly, in November 2001, the airline applied for a federal loan guarantee. In January 2002, it received final approval from the Air Transportation Stabilization Board for a $380 million guarantee.

Supported by that guarantee, AWA was able to borrow $429 million from private lenders and obtain additional concessions and financing (mainly reductions in rent on aircraft it leased and commitments for future financing). That funding allowed AWA to restructure its debt and lease commitments.[24] The AWA loan that the govern-

24. As compensation for rent reductions on aircraft and other concessions, America West issued some of its lessors approximately $104.5 million in convertible senior notes, with an interest rate of 7.5 percent, which were due in 2009 and guaranteed by the company. AWA also converted its existing revolving credit facility into an $89.9 million term loan maturing in 2007.

ment guaranteed had a seven-year term with equal repayments of principal scheduled for years three to seven. It could also be prepaid at any time without penalty. Because of the guarantee, the loan carried a relatively low interest rate—the three-month London interbank offer rate (LIBOR) plus 0.4 percentage points, paid quarterly to the lender.

AWA was also obligated to pay guarantee fees to the government and other loan participants equaling 5.5 percent of the loan balance in the first year and 8.0 percent thereafter. Those fees left the company with a high effective interest rate—LIBOR plus 8.4 percentage points—and thus a strong incentive to prepay the loan if its financial condition improved. As further compensation to the government, America West issued it warrants to purchase up to 18.8 million shares of Class B common stock at $3 per share for 10 years.[25]

Treasury-Rate Subsidy Estimates

The net cost to the government of the AWA and Chrysler guarantees is the cost of the guarantees minus the value of the warrants and guarantee fees. The value of each of those components is affected by uncertainty about default, prepayment, and future asset and stock values. For this analysis, CBO used the same statistical models to estimate the distribution of future cash flows for both the Treasury-rate and market-value estimates so that only the discount rates would differ between the two sets of estimates. To determine the effect of risk adjustment on each component of cost, CBO estimated the value of the guarantees, warrants, and fees separately.[26]

Guarantee Value. Under credit reform, the cost of default is the discounted present value of expected federal outlays to lenders resulting from borrowers' failure to make scheduled payments, net of any recoveries. Currently, those outlays are discounted to the present using the rate on Treasury securities with the same maturities as the cash flows. The first step in estimating that cost, therefore, is to specify the annual distribution of the probability and severity of default.

Various analytical methods are available to model the government's exposure to the risk that a guaranteed borrower will default. A method that takes into account the economic causes of default should be based on the projected path of the value of the borrower's assets. Such an approach, which CBO used to develop market-value estimates as well as Treasury-rate estimates, yields estimates of the probability of default over time and the amounts expected to be recovered in default. In the case of the AWA guarantee, CBO projected the value of the company's assets on the basis of their value at the time of the guarantee and the historical returns on and volatilities of airline-industry assets as a whole. The distribution of Chrysler's future asset values was similarly based on historical returns and volatilities for the auto industry. (For information about the parameter values used in those calculations, see Appendix C.)

Another critical variable in the event of default—the unpaid loan balance—depends in part on the amortization schedule for the guaranteed loan. It is also affected by the probability of voluntary prepayment. The high annual fees paid by AWA suggest that the airline will prepay its loan when it can find more favorable terms from private lenders. In CBO's analysis, prepayment is assumed to occur when AWA's asset value rises above the book value of its liabilities. The loan terms that Chrysler received were more favorable, but the automaker was also projected to prepay its loan if the market value of its assets exceeded the value of its liabilities. In those cases, the quality of both AWA's and Chrysler's credit would probably rise to the point that they could find private financing at a lower rate than that on their guaranteed loan.

The priority of the government's claim in the event of default affects the expected recovery from the borrower. In the case of AWA, the government-guaranteed loan has lowest priority in liquidation proceedings—all other debt holders would be paid before the government. In the case of Chrysler, by contrast, the government-guaranteed loan had highest priority after current liabilities.

25. In addition, other loan participants received warrants to purchase as many as 3.8 million shares of AWA's Class B common stock.

26. The Treasury-rate estimates presented here are not the budget estimates that were made at the time of the guarantees. In 2001, CBO estimated the total cost of the Air Transportation Safety and System Stabilization Act (H.R. 2926), which provided authority for the government to guarantee loans to qualified airlines under terms to be agreed to by the Air Transportation Stabilization Board. CBO estimated that under that act, $8 billion in guarantees would be issued at an average subsidy rate of 25 percent, for a total cost of $2 billion. (At that point, neither the terms of the guarantees nor the specific recipients were known.) The Chrysler guarantee was issued prior to the Federal Credit Reform Act, so it was accounted for in the budget on a cash basis.

Table 1.

Estimated Federal Costs of Loan Guarantees to Chrysler and America West Airlines

(Millions of dollars)

	America West	Chrysler
Treasury-Rate Estimates		
Loan Guarantee	-84.8	-255.5
Warrants	79.7	119.0
Guarantee Fees	52.5	28.9
Net Gain or Loss (-) to the Government	**47.4**	**-107.6**
Market-Value Estimates		
Loan Guarantee	-133.2	-347.5
Warrants	50.4	80.6
Guarantee Fees	56.6	27.9
Net Gain or Loss (-) to the Government	**-26.3**	**-239.0**

Source: Congressional Budget Office.

Note: These estimates reflect conditions when the guarantees were made, not the final results.

CBO discounted expected cash flows from the AWA guarantee at a rate of 4 percent (the rate on seven-year Treasury bonds). That procedure yielded a present-value cost of $84.8 million for the AWA guarantee (see Table 1). For Chrysler, expected cash flows were discounted at the then-prevailing 10-year Treasury rate of 10.52 percent, producing an estimated cost of $255.5 million. In the Treasury-rate calculations, the value of the Chrysler guarantee is three times that of the AWA guarantee mostly because the guaranteed loan to the automaker was much larger (up to $1.5 billion versus $380 million for AWA).

Warrant Values. As noted above, AWA partially compensated the government for the loan guarantee by giving it warrants to buy as many as 18.8 million shares of the company's Class B common stock at an exercise price of $3 per share (the strike price) for a term of 10 years. Those warrants increase in value with the market price of AWA stock and thus provide the government with additional compensation if its guarantee allows the company to return to profitability. Similarly, Chrysler issued warrants to the government to purchase up to 14.4 million shares of Chrysler's common stock, also with a term of 10 years.

CBO calculated the Treasury-rate value of those warrants with the same type of probabilistic analysis that it used to estimate the cost of the guarantees—in other words, it calculated a probability distribution of future stock prices. The sum of the differences between those probability-weighted prices and the strike price is the expected future value of the warrants. Discounting that future value at a risk-free rate (the same 4 percent and 10.52 percent used above) produces Treasury-rate estimates of the warrants' value at the time they were issued: $79.7 million in the case of AWA and $119.0 million in the case of Chrysler.

Fees. The present value of the guarantee fees to be paid to the government depends on the same variables that determine the value of the guarantee itself. The probabilities of default and prepayment every year are especially important because fee income to the government terminates with either event. For each company, CBO used the same assumptions about those variables to value guarantee fees that it used to estimate loan guarantee and warrant values. Besides those probabilities, fee income also depends on the fee rate (a percentage of the outstanding balance) and the amortization schedule of the loan.

AWA agreed to pay guarantee fees of 5.5 percent of the unpaid balance in year one and 8.0 percent in later years as long as the loan was outstanding. Chrysler agreed to pay guarantee fees of 1.0 percent of the unpaid balance each year for the duration of the loan. (In Chrysler's case, the government-guaranteed loan did not have a planned amortization schedule.) Under the current approach, the present value of expected guarantee fees is $52.5 million for AWA and $28.9 million for Chrysler, CBO estimates.

Net Cost. In Treasury-rate terms, when all of the components of the loan guarantee are taken into account, the AWA deal is expected to produce a net gain to the government, in that the value of the warrants and fees that it received exceeds the value of the loan guarantee by $47.4 million (see Table 1). That gain can be attributed to the assumption under the current approach that the price of market risk is zero. Such an assumption creates the appearance that AWA paid the government more than the value of its guarantee. If that were true, then AWA should have rejected the offered terms because it should have

been able to obtain credit support on more-favorable terms privately.

The Treasury-rate estimates for the Chrysler guarantee, by contrast, suggest that the company received a guarantee worth $107.6 million more than the fees and warrants it paid in return.

As those calculations show, accurately estimating the subsidy cost of a loan guarantee under current credit-reform rules requires complex analysis, even in the absence of warrants. From an analyst's perspective, if an appropriate options-pricing model is available, along with the requisite data, the difficulty of estimating that cost should be similar using either approach.

Market-Value Subsidy Estimates

Using an options-pricing method, CBO also estimated the market value of the AWA and Chrysler guarantees from separate estimates of the value of the guarantees, warrants, and fees. Both the market-value and Treasury-rate estimates were based on the same expected cash flows, ensuring that differences between them were attributable to risk adjustment.

Guarantee Value. CBO estimated the market value of each loan guarantee by treating it as a put option held by the borrower to sell the assets of the company to the government at a price equal to the unpaid loan balance for the life of the loan (see Box 1). To calculate the price of the option, CBO used a binomial options-pricing model.[27] The information needed to value the loan guarantee using that method is identical to that required for the Treasury-rate estimates. Further, defaults and prepayments are assumed to be triggered by the same conditions as those used for the Treasury-rate estimates.[28] On the basis of that options-pricing approach, CBO estimates that the AWA guarantee had a fair-market value of $133.2 million; and the Chrysler guarantee, $347.5 million (see Table 1).

Warrant Values. Determining the market value of the warrants granted to the government is a relatively simple calculation.[29] Again, the underlying cash flows are the same as for the Treasury-rate estimates; only the discount rate is different.

The market-based estimates of the value of the warrants differ substantially from the Treasury-rate estimates because warrants have significant exposure to market risk. CBO's options-pricing analysis estimates a warrant price of $2.67 per AWA share, or a total market value of $50.4 million for 18.8 million common shares, compared with $79.7 million under the current approach. For Chrysler, the market-value estimate of the warrant price is $5.60 per share, or $80.6 million for 14.4 million shares, versus $119.0 million using Treasury rates. Those differences result from recognizing the cost of market risk.

Fees. CBO estimated the value of the guarantee fees, like the value of the guarantee itself, using a binomial options-pricing model. The inputs are the same as those used to value the cost of the guarantee, with the addition of the schedule for guarantee fees.

For AWA, the expected value of guarantee-fee payments to the government is $56.6 million, about $4 million more than the estimate using the current approach. Conversely, Chrysler's guarantee-fee payments to the government have an expected value of $27.9 million, about $1 million less than the Treasury-rate estimate. The market-value estimates of guarantee fees can be either higher or lower than the Treasury-rate estimates because of the different effects that prepayment and default have on the market risk of such fees.[30] In contrast, the estimated cost of guarantees is consistently higher under market valua-

27. See McDonald, *Derivatives Markets,* Chapters 10 and 11. That model is also sometimes referred to as the Cox-Ross-Rubinstein pricing model after its developers. CBO used a binomial model rather than the more familiar Black-Scholes model because it yields more-accurate values by accounting for specific features of loan guarantees.

28. For more details, see Appendix C and the companion technical paper by the authors of this report, "Valuing Federal Loans and Loan Guarantees Using Options-Pricing Models," available at www.cbo.gov/Tech.cfm.

29. CBO used a version of the Black-Scholes model to calculate warrant values.

30. The flow of guarantee fees to the government stops when the borrower prepays or defaults. If the borrower is more likely to default than to prepay, the market value of fees tends to be lower than under the current approach because the guarantee fees are positively correlated with the economy. Conversely, if prepayment is more likely than default, the market value of the fees tends to be higher because the fees are more likely to continue in bad economic conditions and end in good conditions.

Table 2.

Estimated Subsidy Rates for Federal Loan Guarantees to Chrysler and America West Airlines

(Percentage of amount guaranteed)

	America West		Chrysler	
	Treasury-Rate Estimate	Market-Value Estimate	Treasury-Rate Estimate	Market-Value Estimate
Loan Guarantee	-22.3	-35.1	-17.0	-23.2
Warrants	21.0	13.3	7.9	5.4
Guarantee Fees	13.8	14.9	1.9	1.9
Net Government Subsidy	**12.5**	**-6.9**	**-7.2**	**-15.9**

Source: Congressional Budget Office.

tion than under the current approach, and the estimated value of warrants is consistently lower.[31]

Net Cost. The market-value estimates of the AWA and Chrysler guarantees (including all parts of the transactions) are higher than the estimates produced under current credit-reform rules. Moreover, both transactions are estimated to cost the government money—$239.0 billion in the case of Chrysler and $26.3 billion in the case of AWA—which indicates that the government gave greater value than it received in those deals. That result is consistent with the proposition that if the government had charged more than the market price for credit assistance, the borrowers would have been able to obtain such assistance at a lower cost from the private sector.

The Effect of Market Risk on Subsidy Rates

Converting those Treasury-rate and market-value estimates to a percentage of the amount guaranteed produces estimated subsidy rates for the various components of the loan guarantees (see Table 2). The government received much higher rates of compensation in fees and warrants from AWA than from Chrysler. For the warrants, Chrysler's strike price was so far above its market price that the probability that the warrants would be exercised was small, resulting in a low estimated warrant value under both methods. The AWA warrants were "in the money" when they were issued (in other words, valuable even if exercised immediately) and thus were much more likely to be of value to the government. AWA also agreed to considerably higher guarantee fees. Nevertheless, the AWA deal still involved a net government subsidy of 6.9 percent on a market-value basis. The Chrysler guarantee, by comparison, involved a federal subsidy of 15.9 percent.

Those overall subsidy rates differ substantially from the ones in the Treasury-rate estimates. The market-value subsidy rates for both Chrysler and AWA are more than double the rates estimated under current credit-reform rules. Those differences result solely from including the market price of risk.

Uncertainty and Reestimates

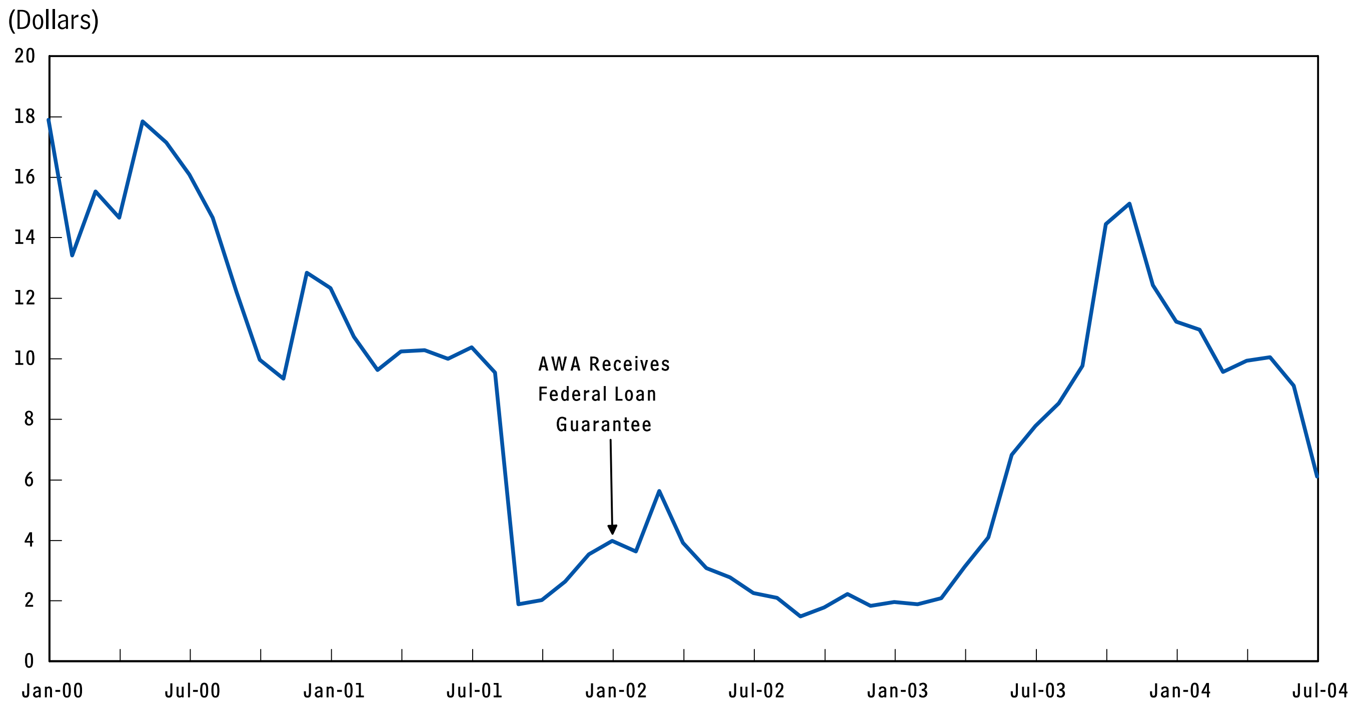
Federal budget analysts initially estimate subsidy costs when a loan guarantee is extended; hence, those estimates are subject to uncertainty about the ultimate costs. Information available when the guaranteed loans were made indicated that the AWA and Chrysler guarantees would be expensive to the government. In fact, both deals may end up being favorable for the government. Chrysler repaid its guaranteed loan in full by September 1983. Instead of holding on to the warrants, the Treasury sold them in a sealed-bid auction. Chrysler bought back its warrants for $21.60 a share, yielding the government $311 million. AWA's guaranteed loan is still outstanding. The year after the guarantee was made, the company's

31. The reason is that the payoff to the government from warrants is highest in good economic conditions, when resources are more plentiful and thus less highly valued, and is lowest in bad economic conditions. The opposite is true with guarantees: they require the most government resources during bad times, when resources are scarcer and thus more highly valued.

Figure 1.

AWA Stock Prices, January 2000 to July 2004

(Dollars)



Source: Standard & Poor's COMPUSTAT database.

stock price declined, but it rebounded thereafter (see Figure 1). In March 2004, the price stood at more than $9 per share, implying that if the government exercised its $3 per-share warrants at that price, it would gain more than $100 million. (Since then, AWA's stock price has declined further, but at $6 per share, it remains above the warrant price.)

Those cases might suggest that Treasury-rate subsidy estimates are too high rather than too low. However, a more valid conclusion is that such estimates are uncertain. In fact, many examples exist of loan guarantees whose value has deteriorated over time. For instance, the $100 billion in loan guarantees that the Federal Housing Administration's Mutual Mortgage Insurance Fund made in 2000 were initially estimated to net the government approximately $2 billion. Since then, that estimate has been revised three times to indicate progressively smaller expected gains. Currently, those loan guarantees are projected to net only about $680 million—one-third of the amount originally estimated.[32]

The Federal Credit Reform Act recognizes that subsidy costs are uncertain and that realized gains and losses will deviate from initial estimates. It deals with that uncertainty in a logical way: by allowing analysts to make the best estimate possible when a loan or guarantee is originated and then revise that estimate as new information becomes available. Under the FCRA, initial subsidy estimates are reestimated over the life of a loan or guarantee to reflect actual cash flows and other factors.[33] The original estimate plus the sum of lifetime reestimates equals the realized subsidy. Consistent with the principles of accrual accounting, those reestimates are included in annual budget outlays and in the budget deficit or surplus.[34]

Market-value reestimates can be calculated analogously to Treasury-rate reestimates, using the same models initially

32. See the Office of Management and Budget's annual *Federal Credit Supplement* for fiscal years 2003, 2004, and 2005, Table 8.

33. The Office of Management and Budget currently requires two types of reestimates. The first type is a one-time adjustment for interest rates, which corrects for any discrepancy between interest rates at the time of the original estimate and interest rates at the time the loans are disbursed. The second type is an annual technical reestimate, which adjusts for factors such as changes in prepayments, defaults, and recoveries (but not interest rates).

34. See Congressional Budget Office, *Credit Subsidy Reestimates, 1993-1999* (September 2000).

Table 3.

Initial and Reestimated Federal Costs from the Loan Guarantee to America West Airlines

(Millions of dollars)

	Original Estimate	January 2003 Reestimate	January 2004 Reestimate
Loan Guarantee			
Market-Value Estimate	-133.2	-241.8	-8.2
Treasury-Rate Estimate	-84.8	-189.9	-3.9
Warrants			
Market-Value Estimate	50.4	13.7	231.6
Treasury-Rate Estimate	79.7	24.2	249.1
Guarantee Fees			
Market-Value Estimate	56.6	47.2	6.1
Treasury-Rate Estimate	52.5	50.2	4.8
Net Gain or Loss (-) to the Government			
Market-Value Estimate	-26.3	-180.9	229.6
Treasury-Rate Estimate	47.4	-115.5	250.0

Source: Congressional Budget Office.

Note: Reestimates are recorded in the federal budget as the change in subsidy value since the previous estimate or reestimate. For clarity, this table shows the subsidy value, not its change.

used to calculate subsidy values.[35] Reestimation involves updating the parameters of a model to reflect differences between initial assumptions and current information. For comparative purposes, CBO calculated both types of reestimates for the AWA loan guarantee.[36] In that case, the key variable driving the reestimates is stock price. The drop in the company's stock price during the first year that the loan was outstanding implies a significant increase in the probability and severity of future default and thus a sharp decline in the value of the warrants. Both of those factors increase the estimated subsidy cost of the guarantee after one year—from a government gain of $47.4 million to a loss of $115.5 million under current credit-reform rules or from a loss of $26.3 million to a loss of $180.9 million with market risk taken into account (see Table 3). By January 2004, however, AWA's greatly improved financial condition changed the net subsidy cost into an expected gain: of $250.0 million in the Treasury-rate estimates or $229.6 million in the market-value estimates.

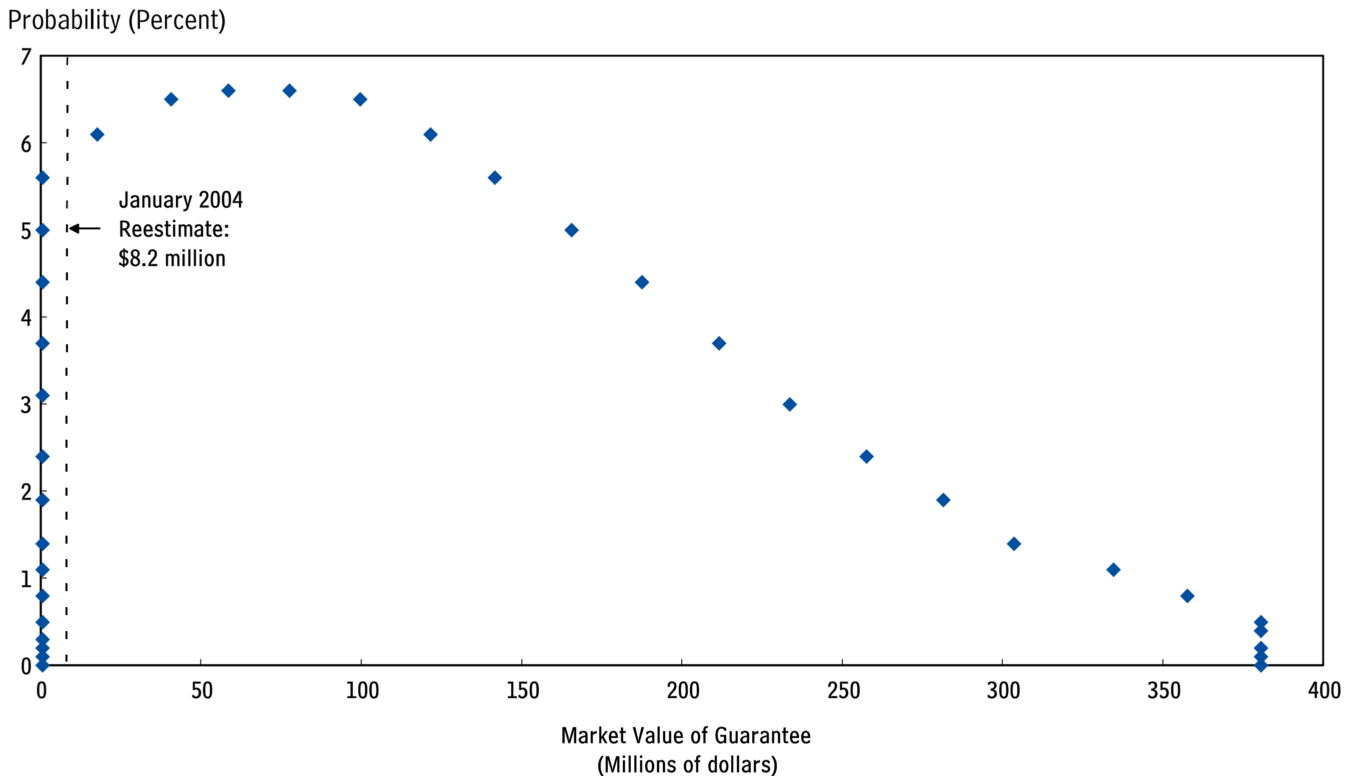
The probabilistic models that underlie both the Treasury-rate and market-value estimates are useful for depicting the probability distribution of future guarantee costs and thus the uncertainty associated with the initial cost estimates. The probability distribution of the future market value of the AWA guarantee, projected forward two years from January 2002 (when the guarantee was approved), is shown in Figure 2. That guarantee value has a lower bound of zero, which reflects the possibility of a large increase in asset value that enables AWA to prepay the loan, extinguishing the value of the guarantee. It has an upper bound of $380 million, the figure that results when AWA's asset value falls to the point where default occurs and the government recovers nothing from the company. The distribution in Figure 2 suggests that the most probable event, looking ahead two years, is a market value between $50 million and $100 million for the AWA guarantee. In that case, the company would still be operating, but the guarantee would remain costly to the gov-

35. To account for the price of risk more accurately, the reestimate could be adjusted with a charge for market risk.

36. CBO did not produce reestimates for the Chrysler guarantee because the requisite historical data were not readily available.

Figure 2.

Probability Distribution of Market Values of the AWA Loan Guarantee



Source: Congressional Budget Office.

Note: These numbers are two-year projections looking forward from January 2002, when the America West Airlines (AWA) loan guarantee was approved.

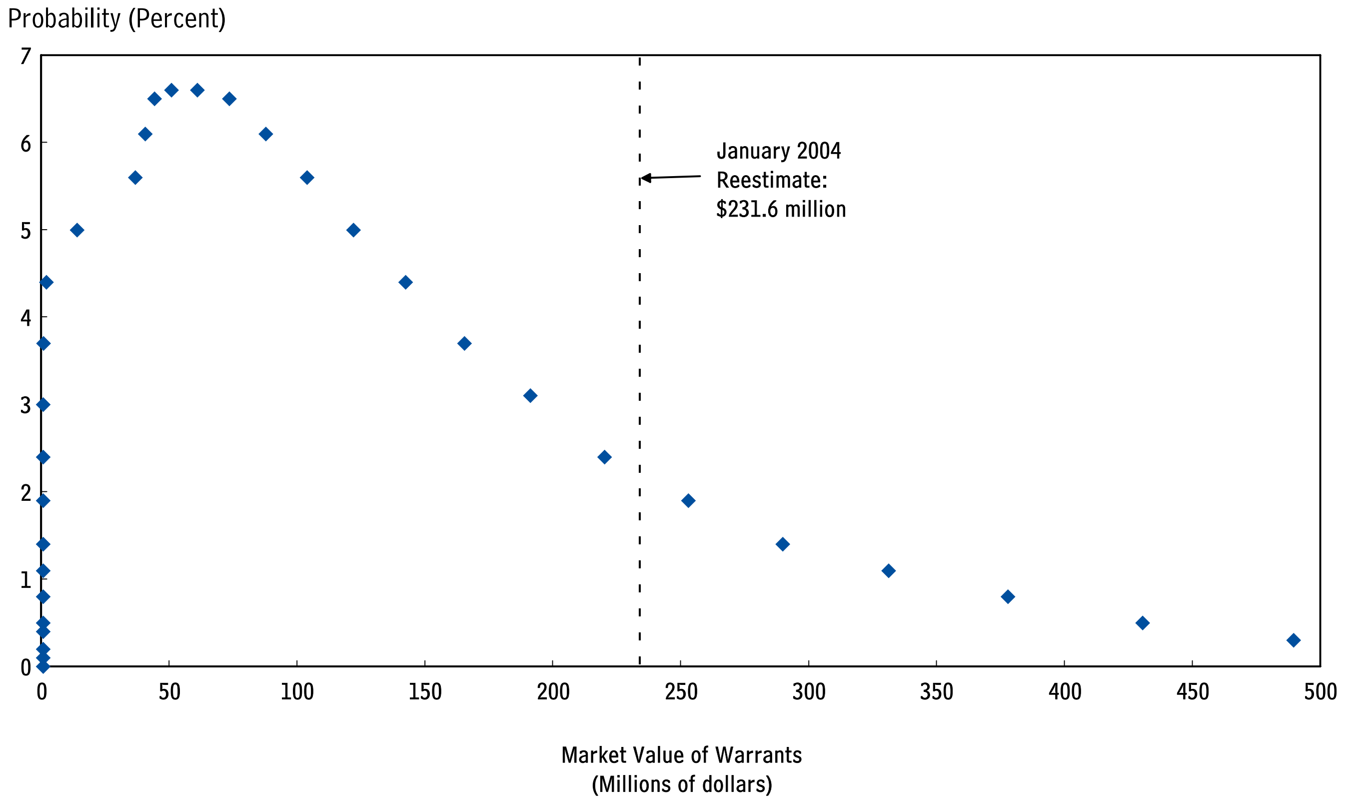
ernment because of the significant possibility of a default during the five years left on the loan.

The projected market-value distributions of fee income and warrant values can be obtained similarly by projecting the distributions of future cash flows from fees and warrants. (The distribution for warrant values is shown in Figure 3.) Indeed, much of the variation in CBO's reestimates for AWA can be attributed to the high volatility of future warrant values, which is a consequence of the company's highly volatile stock price.

The distributions of future guarantee and warrant values shown in Figures 2 and 3 reveal that the January 2004 reestimates for AWA were extremely unlikely from the perspective of January 2002. The vertical line in Figure 2 indicates the guarantee value corresponding to AWA's asset value at the end of 2003. As the figure illustrates, the probability of such a large reduction in guarantee value was small. Similarly, the vertical line in Figure 3 indicates that it was extremely unlikely that the value of the warrants would rise to the level that occurred.

Figure 3.

Probability Distribution of Market Values of the AWA Warrants



Source: Congressional Budget Office.

Note: These numbers are two-year projections looking forward from January 2002, when the America West Airlines (AWA) loan guarantee was approved.

APPENDIX

A

Volume and Cost of Federal Credit Programs

The tables in this appendix offer a sense of the scale of the federal government's credit programs by detailing the total amounts of direct loans and loan guarantees that were outstanding at the end of each of the past 10 fiscal years (see Table A-1). They also show the budget authority provided for the subsidy costs of those loans and guarantees in 2003 (see Table A-2). In both cases, the numbers are broken down by major credit programs.

Table A-1.

Federal Direct and Guaranteed Loans Outstanding, 1994 to 2003

(Billions of dollars)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
					Direct Loans					
Ford Student Loans	*	2.8	11.6	21.2	31.7	45.8	57.7	70.5	80.1	84.5
Rural Housing and Community Development	35.3	36.2	36.3	36.4	36.3	35.2	33.3	33.5	33.4	32.9
Rural Electrification, Telephone, and Telecommunications	37.6	37.4	35.5	34.0	33.6	33.1	32.1	31.2	31.7	32.1
Export-Import Bank	7.5	7.6	7.9	10.1	10.8	12.2	11.1	11.7	11.4	11.1
Other	78.8	79.3	75.2	79.7	73.4	74.1	73.9	66.4	63.4	58.7
Total	**159.2**	**163.3**	**166.5**	**181.4**	**185.8**	**200.4**	**208.1**	**213.3**	**220.0**	**219.3**
					Loan Guarantees					
FHA Housing	381.9	401.4	455.2	448.6	469.6	504.1	548.5	557.9	563.4	496.4
VA Housing	155.0	154.5	154.8	170.5	200.2	221.3	224.3	236.9	264.5	323.1
FFEL Student Loans	75.0	86.1	101.9	101.0	100.5	126.7	144.2	159.3	181.9	213.3
Small Business Administration	23.6	28.6	30.9	35.2	37.5	39.4	33.8	36.6	41.1	53.4
Export-Import Bank	16.8	17.8	17.8	22.1	21.8	25.4	29.8	30.5	31.0	33.5
Other	46.5	38.4	45.5	44.5	52.1	58.9	62.3	62.9	63.7	64.8
Total	**698.8**	**726.8**	**806.1**	**821.9**	**881.7**	**975.8**	**1,042.9**	**1,084.1**	**1,145.6**	**1,184.4**

Source: Congressional Budget Office based on data from the Office of Management and Budget.

Notes: * = less than $50 million; FHA = Federal Housing Administration; VA = Department of Veterans Affairs; FFEL = Federal Family Education Loan program.

Excludes defaults on guarantees that result in recoveries. Excludes secondary loan guarantees issued by the Government National Mortgage Association.

Table A-2.

Budget Authority for Subsidies for Federal Direct and Guaranteed Loans, 2003

	Budget Authority (Millions of dollars)
Direct Loans	
Rural Housing and Community Development	288
Agricultural Credit and Community Advancement	259
International Debt Restructuring	211
Small Business Disaster Loans	117
Rural Electrification, Telephone, and Telecommunications	-36
Ford Student Loans	-318
Other	136
Total	**657**
Loan Guarantees	
Federal Family Education Loan Program Student Loans	6,411
Department of Veterans Affairs Housing	547
Export-Import Bank	320
Air Transportation Stabilization	180
Commodity Credit Export Loans	170
Small Business Administration	118
Federal Housing Administration	-3,584
Other	5
Total	**4,167**

Source: Congressional Budget Office based on data from the Office of Management and Budget.

APPENDIX

B

An Example of Using the Binomial Model to Price a Loan Guarantee

Assume that the federal government guarantees the repayment of principal and interest on $90 million in debt coming due in one year issued by a company with assets of $100 million. The guarantor has effectively given the owner of the company the equivalent of a "put option" on the company's assets with a "strike price" of $90. That is, the guarantee gives the borrower (the company) the right to sell its assets to the guarantor for $90, whatever their current market value. Suppose that in one year, those assets will be worth either $140 million or $70 million (as shown in the top tree diagram in Figure B-1). If the asset value rises to $140 million, the firm will be able to repay its $90 million debt without any contribution from the federal government. If the asset value falls to $70 million, however, the company will be unable to meet its debt obligation. In that case, it will "put" its assets to the government, which will pay $90 million to the lender and sell the assets for $70 million.

Thus, the tree of the borrower's asset values in Figure B-1 implies the tree of cash flows for the government guarantor shown in the middle diagram of the figure. If the company's asset value increases, the guarantee requires no payment by the government (the put option will expire unexercised); but if the asset value falls, the government will face net costs of $20 million ($90 million minus $70 million) to honor its guarantee.

The cost to the government of that guarantee when it is issued is the present value (P) of the distribution of possible cash flows in one year. That value can be inferred from the price of a portfolio composed of assets of the borrowing firm and risk-free bonds that has the same payoff to the government as the guarantee. If the payoffs are the same, the cost must be the same, and the cost of the guarantee can be inferred from the known prices of the borrower's assets and risk-free bonds.

Suppose a risk-free zero-coupon bond with a face value of $100 and a maturity of one year has a current price of $95. Because the bond is risk-free, its value will be $100 in one year regardless of what happens to the value of the firm's assets (see the bottom tree diagram in Figure B-1). The problem of the value of the loan guarantee is thus reduced to the following question: how many risk-free bonds (X) and units of the borrower's assets (Y) are required to generate the same payoff as the guarantee? The payoffs for both the guarantee and the portfolio need to match in both good and bad states of the economy. Thus:

$X100 + Y140 = 0$ (good states)
$X100 + Y70 = -20$ (bad states)

Those two equations can be solved for X and Y: $X = -0.4$ and $Y = 0.2857$. The price of the portfolio—based on the $95 price of the bond and the $100 current asset value—is -0.4($95) + 0.2857($100) = -$9.43. Thus, the guarantee is equivalent to selling -0.4 of the risk-free bonds (borrowing 0.4 x $95) at the risk-free rate and buying 0.2857 of the assets. And the cost of the guarantee is the value of the portfolio, or -$9.43.

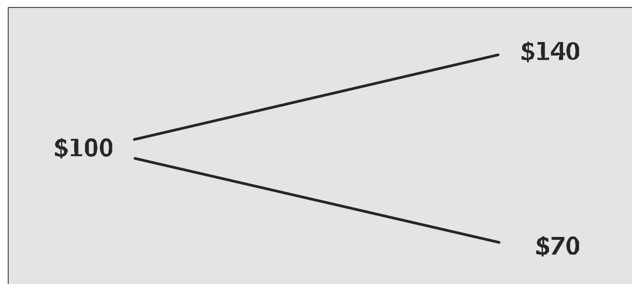
The value of that guarantee, or option, was inferred without an explicit assumption or information about the probabilities of the two possible outcomes. In valuing the federal loan guarantees to Chrysler and America West Airlines, however, the probabilities of up and down moves and the asset value of an up move were estimated using a required rate of return on company assets and the volatility of that return.

To illustrate the relationship among those variables, assume that the probability of an up move is 0.6 and that of a down move is 0.4. Those probabilities are consistent with an expected rate of return on assets of 12 percent (because [0.4(70) + 0.6(140)]/1.12 = 100). The risk-free interest rate can also be inferred from the equation 100/(1 + r) = 95, which implies a rate of 5.26 percent.

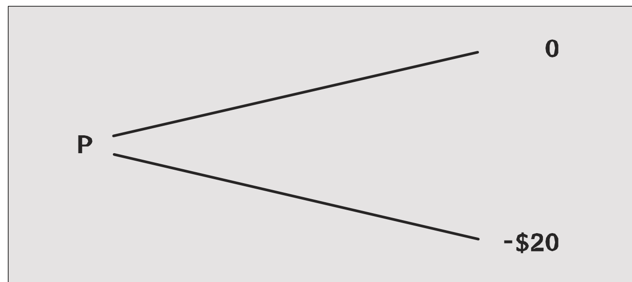
Figure B-1.

Illustrative Possible Values of Assets, Cash Flows, and Bonds in One Year

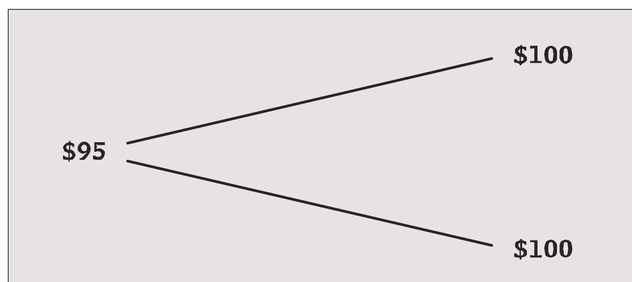
Possible Values of Borrower's Assets in One Year



Possible Values of Government's Cash Flows from Guarantee in One Year



Possible Values of Government Zero-Coupon Bond in One Year



Source: Congressional Budget Office.

The government as guarantor has a portfolio position equivalent to a highly leveraged position in the firm's assets—that is, issuing debt of $38 (0.4 x $95) and buying $28.57 of the firm's assets. The market value of that portfolio is -$9.43, which is the fee the guarantor must be paid to accept the chance of losing $20. Using the probabilities inferred from market returns, the expected loss is 0.4($20) = $8.

Viewed from the lender's perspective, the lender values an expected payment of $8 in one year at $9.43 today. The discount rate implied by 8/(1 + r) = 9.43 is -15.16 percent, or about 20 percentage points lower than the risk-free rate of 5.26 percent. The expected loss of $8 discounted at 5.26 percent has a present value of $7.60, which understates the value of the guarantee by about 19 percent.

That example illustrates that although future cash outflows on loan guarantees are risky, their risk-adjusted discount rate (unlike that of future cash inflows on loans) is not higher than the risk-free rate. The market implicitly discounts expected guarantee payments at an interest rate below the risk-free rate. The reason is that a loan guarantee transfers market risk from the lender to the guarantor. For the guarantor to get a commensurate return for assuming the market risk, the expected payments must be discounted at a rate lower than the risk-free rate. The borrower is paying the risk-free rate to the lender plus compensation to the guarantor for taking on the market risk, which has the effect of making the market value of the guarantee higher than the value obtained from discounting at the risk-free rate or an upwardly adjusted rate. Indeed, the guarantee has more market risk than the underlying assets because the guarantee is equivalent to a leveraged position in the assets, which always has more risk than the assets themselves do.

APPENDIX

C

Parameter Estimates and Modeling Assumptions Used in This Analysis

This appendix provides additional information about some of the key parameters and behavioral rules that the Congressional Budget Office (CBO) used to estimate the value—under both current credit-reform rules and market valuation—of federal loan guarantees to Chrysler and America West Airlines (AWA). A companion technical paper by the authors of this report, titled "Valuing Federal Loans and Loan Guarantees Using Options-Pricing Methods," contains details about the underlying options-pricing models.[1]

Asset Volatility

A critical input into both Treasury-rate and options-based estimates is the volatility of a firm's asset value. Although that volatility is not directly observable, it can be estimated in a variety of ways. For AWA, this study uses a formula implied by the Black-Scholes options-pricing model:

C1) Volatility of Assets = Volatility of Equity (beta of Assets/beta of Equity)

The "beta" of a stock or asset is a measure of the correlation of its returns with those of the overall market. For publicly traded companies, estimates of equity betas are available from various public sources. Estimates of asset betas are also available for many industries.

The equity beta of AWA's stock is 1.55.[2] The beta of AWA's assets was set to equal the unlevered beta of the airline industry (to remove the effect of debt), which is estimated at 0.67.[3] The equity-volatility range that AWA uses to value its employee stock options is 44.9 percent to 60 percent. On the basis of those parameters, CBO estimated the asset volatility at 19.4 percent to 25.9 percent. The estimates reported in this study use the high end of that range since it accords with independent estimates of asset volatility for the airline industry.

CBO used a different method to estimate asset volatility for Chrysler because not all of the necessary inputs for equation C1 were readily available. That company's asset volatility was set to equal an average asset volatility for several firms in the automotive industry.[4] The current average volatility for automotive firms is 22.5 percent. Although the equity volatility of a particular company can change substantially in a short time, the asset volatility of an industry is likely to be more stable. Nonetheless, the 22 years between 1980 and 2002 are long enough for asset volatility to have altered greatly, and a more careful measure of that variable is recommended for any actual cost estimate.

Market Value of Assets

For healthy publicly traded firms, adding the market value of equity to the book value of debt liabilities approximates the market value of assets. For financially distressed companies, the book value of debt is likely to be much higher than its market value, but obtaining accurate estimates of that market value is difficult. As explained in the companion technical paper, an options-pricing formula can be used interactively to estimate the

1. That paper is available at www.cbo.gov/Tech.cfm.
2. Market data for AWA from Bloomberg (www.bloomberg.com).
3. "Damodaran Online," Web site of Prof. Aswath Damodaran, Stern School of Business, New York University (www.stern.nyu.edu/~adamodar).
4. Ibid.

market value of assets without requiring an estimate of the market value of debt. That is the approach that CBO took for this analysis.

Using options-pricing formulas to estimate the market price of assets requires the following six measures:

- Market value of equity,
- Volatility of returns on assets,
- Volatility of returns on equity,
- Risk-free interest rate,
- Strike price of the option, and
- Maturity of the debt.

For AWA, the initial market value of equity is $138 million (based on a share price of $4 and 34.6 million outstanding shares). The volatility of assets is 25.9 percent (as described above), and the volatility of equity is 50 percent. The risk-free rate is 3.5 percent (as described below). The strike price of this option is the book value of all of AWA's liabilities as reported in the company's 10-Q report for the first quarter of 2002 filed with the Securities and Exchange Commission, or $1,575 million (including pay-in-kind interest payments on AWA's convertible senior notes during the first three years). The time to maturity of the call option is the weighted average time to maturity of all of AWA's liabilities, or 3.82 years. The resulting estimate of the market value of the company's assets is $1,113 million.

The calculation for Chrysler is similar. The market value of equity is $319 million (based on a share price of $7.5 and 42.5 million shares outstanding). The volatility of assets is 22.5 percent, and the volatility of equity is based on the implied volatility of long-term warrants and set at 70.5 percent. The risk-free rate is 10.02 percent (see below). The strike price for this option is the book value of all liabilities that Chrysler reported in its annual report for 1980, or $6,957 million (including preferred stock). The time to maturity of the call option is the weighted average time to maturity of all of Chrysler's liabilities, or 3.68 years. The market value of Chrysler's long-term assets is thus estimated to be $3,750 million.

Default Triggers

If a firm's asset value falls below the "default trigger," the options-pricing models assume that a default occurs—in other words, that the put option is exercised—and any residual asset value is used to pay claimants (including the government) in order of their legal priority. In practice, the point at which firms declare bankruptcy varies considerably. Some companies hang on with very low asset values, whereas others seek the protection of bankruptcy court before they are forced to do so by creditors. As a result, some judgment is required in choosing a default trigger.

The default trigger for AWA was set as a function of time based on the company's debt repayment schedule. For instance, for the first year after the loan guarantee was issued (year one), the default trigger was set equal to the book value of current liabilities, as described in AWA's 10-Q report for the first quarter of 2002. For year two, the default trigger is the sum of the current liabilities and the debt obligations coming due in the second year. That procedure is continued for the life of the government-guaranteed loan.

The assumption implicit in that procedure is that AWA can pay back principal due every year by refinancing it with short-term debt. One could argue that AWA can refinance maturing debt using long-term debt and, therefore, that its default trigger should not increase with time. Although that is a plausible argument, lenders will subject AWA to more-stringent requirements on its market value if the company chooses to issue long-term debt than they will if it issues short-term debt. In other words, the market value of AWA's assets must be higher if it wants to refinance with long-term debt. In light of those two competing effects on the possibility of bankruptcy —that issuing short-term debt raises the default trigger whereas issuing long-term debt sets more-stringent requirements on a firm's value at the time of refinancing—CBO believes that the procedure it used to set the default limit is a reasonable approximation.

The assumptions for Chrysler are similar. The default trigger is a function of time based on the company's schedule of debt repayments. For the first year, the default trigger is the book value of Chrysler's current liabilities. For year two, it is the sum of the current liabilities and half of the "other liabilities and deferred credits" reported on Chrysler's balance sheet, or $646 million. Since

the company's long-term liabilities are nonamortizing, they do not change the default limit.

Prepayment Triggers

AWA has a strong incentive to prepay its high-cost government debt if it regains financial health. This analysis assumes that AWA prepays the government-guaranteed loan immediately if the market value of its assets exceeds the book value of its liabilities ($1,575 million). Clearly, that assumption is an oversimplified view of the firm's behavior, but it reflects the fact that AWA will want to pay off high-cost government-guaranteed debt as soon as feasible.

Although the financial incentives for prepayment were weaker with the Chrysler guarantee, CBO assumed that Chrysler would prepay its government-guaranteed loan if the market value of its assets exceeded the book value of its liabilities ($6,957 million).

Risk-Free Rate

The risk-free interest rate required in the binomial options-pricing model is the average short-term rate expected to prevail over the life of the loan guarantee. For the AWA guarantee, that rate was estimated from the yield on seven-year Treasury notes, which consists of expected short-term rates over the seven years and a liquidity premium. The seven-year Treasury yield in January 2002 was about 4.0 percent. Assuming a liquidity premium of 0.5 percentage points (consistent with historical averages) results in a risk-free rate of 3.5 percent. The rate for the warrant calculations was set at 4.0 percent because of the warrants' 10-year maturity.

The risk-free rate for Chrysler was estimated from the yield on 10-year Treasury notes, which also consists of expected short-term rates and a liquidity premium. The 10-year Treasury yield at the time of Chrysler's loan guarantee was 10.52 percent. Assuming a liquidity premium of 0.5 percentage points produces a risk-free rate of 10.02 percent.

TAB F - Other Materials

The Cost of the Savings and Loan Crisis: Truth and Consequences

by Timothy Curry and Lynn Shibut*

It has been more than a decade since enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which began the taxpayers' involvement in the cleanup of the savings and loan industry.[1] Over time, misinformation about the cost of the crisis has been widespread; some published reports have placed the cost at less than $100 billion, and others as high as $500 billion.[2] Now that the cleanup is nearly complete, we can answer the following questions about a debacle that has consumed the nation for years:

- What was the total cost of the crisis?
- How much of the total was borne by the U.S. taxpayer?
- How much was borne by the thrift industry?
- How do the actual costs compare with those predicted before and during the cleanup years?

The thrift cleanup was Congress's response to the greatest collapse of U.S. financial institutions since the 1930s. From 1986 to 1989, the Federal Savings and Loan Insurance Corporation (FSLIC), the insurer of the thrift industry, closed or otherwise resolved 296 institutions with total assets of $125 billion (table 1).[3] An even more traumatic period followed, with the creation of the Resolution Trust Corporation (RTC) in 1989 and that agency's resolution by mid-1995 of an additional 747 thrifts with total assets of $394 billion.[4] The combined closings by both agencies of 1,043 institutions holding $519 billion in assets contributed to a massive restructuring of the number of firms in the industry. From January 1, 1986, through year-end 1995, the number of federally insured thrift institutions in the United States declined from 3,234 to 1,645, or by approximately 50 percent.[5]

* Timothy Curry is a financial economist and Lynn Shibut is Chief of the Financial Modeling Section in the FDIC's Division of Research and Statistics. The authors thank the FDIC's James Marino, Barry Kolatch, George Hanc, John Thomas, and Karen Hughes for helpful comments, and Katie Wehner and Sandy Hinegardner for research assistance. Matthew Green of the Treasury Department contributed useful suggestions.

[1] Although the roots of the savings and loan crisis lay in the late 1970s, the passage of FIRREA in 1989 marked the first time taxpayer funds were used to resolve the crisis. That use of taxpayer funds to meet the guarantee to insured depositors is the reason the term *cleanup* is used rather than *bailout*.

[2] For example, see White (1991), 197. Also, Thomas (2000), 13.

[3] The word *thrifts* refers to savings associations insured by the FSLIC until August 8, 1989, and after that date by the Savings Association Insurance Fund (SAIF), administered by the FDIC.

[4] The $394 billion figure measures total assets as reported in the Thrift Financial Report that was most recent at the time of each thrift's failure. This figure is net of valuation allowances on the books of the institution at the time of failure. Other published numbers have reported the total assets for the 747 thrifts at takeover to be $402.4 billion. This reported number is gross of valuation allowances. Unless otherwise noted, the source for all data is the FDIC.

[5] The total number of thrift institutions represents those that were FSLIC-insured at year-end 1986 and SAIF-insured at year-end 1995. It should be noted that not all of the thrift industry consolidation occurred because of the thrift crisis. Even without such a crisis, some consolidation of the industry would probably have occurred.

Table 1
Thrift Failures, 1986–1995
($Millions)

Year	FSLIC Number	FSLIC Assets	RTC Number	RTC Assets
1986	54	$ 16,264		
1987	48	11,270		
1988	185	96,760		
1989	9	725	318	$134,520
1990			213	129,662
1991			144	78,899
1992			59	44,197
1993			9	6,148
1994			2	137
1995			2	435
Total	**296**	**$125,019**	**747**	**$393,998**

Source: FDIC.
Note: Data are for the period January 1, 1986, to December 31, 1995.

Although the roots of the thrift crisis stretch back to the late 1970s, the financial losses experienced by taxpayers and the industry are tabulated as beginning on January 1, 1986, and ending at year-end 1995. The year 1986 was selected as the starting point because this was the first year when the FSLIC was reported insolvent. Before then, the thrift insurance fund had been able to cover losses from thrift failures. Recognition of the FSLIC's insolvency as of year-end 1986 marked a watershed: at that time many observers realized that taxpayer involvement in the resolution of the crisis was a strong possibility.

The next section of this article provides background material on the crisis. It is followed first by a retrospective on the changing estimates of the size of the thrift problem over time and then by a three-part section identifying and analyzing the cost of meeting the deposit insurance obligations that remained in the wake of the debacle. The costs are broken into the FSLIC and RTC segments, as well as the taxpayer and the thrift industry shares of each, and the total is then analyzed. A brief summary concludes. An appendix discusses the "goodwill" litigation associated with FIRREA.

Background

The causes and severity of the thrift crisis have been documented by scholars for more than a decade.[6] Several reasons cited for the collapse include:

- high and volatile interest rates during the late 1970s and early 1980s, which exposed thrifts to interest-rate risk (caused by a mismatch in duration and by interest-rate sensitivity of assets and liabilities);
- the phase-out and eventual elimination in the early 1980s of the Federal Reserve's Regulation Q, which caused increasing costs of thrift liabilities relative to many fixed-rate assets and adversely affected industry profitability and capital;
- adverse regional economic conditions;
- state and federal deregulation of depository institutions, which allowed thrifts to enter new but riskier loan markets;
- the deregulation of the thrift industry without an accompanying increase in examination resources (for some years examiner resources actually declined);
- reduced regulatory capital requirements, which allowed thrifts to use alternative accounting procedures to increase reported capital levels;
- excessive chartering of new thrifts during the 1980s;
- the withdrawal in 1986 of federal tax laws (enacted in 1981) that benefited commercial real-estate investments;
- the development during the 1980s of the brokered deposit market; and
- delays in funding the thrift insurance fund during the 1980s and the RTC during the 1990s, which led to regulators' failure to close many insolvent institutions in a timely manner.

As a consequence of all these factors, during the 1980s the thrift industry realized unprecedented losses on loans and investments. The result, as noted, was the failure of hundreds of thrift institutions and the insolvency by year-end 1986 of the FSLIC, the federal insurer for the thrift industry. As of year-end 1986, 441 thrifts with $113 billion in assets were book insolvent, and another 533 thrifts, with $453 billion in assets, had tangible capital of no more than 2 percent of total assets. These 974 thrifts held 47 percent of industry assets. In response, Congress created the Financing Corporation (FICO) in 1987 to provide funding to the FSLIC by issuing long-term bonds. By the time FIRREA was passed two years later, FICO had contributed $8.2 billion in financing to the

[6] *See* Barth *et al.* (1985); Kane (1989); Barth (1991); White (1991); Barth and Brumbaugh (1992); Bennett and Loucks (1996); and FDIC (1997).

Table 2
Chronology of Thrift Crisis Events

December 31, 1986	FSLIC insolvent
August 10, 1987	FICO created to fund FSLIC
August 9, 1989	Enactment of FIRREA
	– FSLIC abolished
	– FRF created (succeeds to FSLIC's assets, liabilities, and operations)
	– SAIF created to handle thrift failures starting August 9, 1992
	– RTC created to resolve thrifts placed into conservatorships or receiverships between January 1, 1989 and August 8, 1992[a] (RTC to cease operations December 31, 1996)[b]
	– REFCORP created to fund RTC

Note: FSLIC = Federal Savings and Loan Insurance Corporation
FICO = Financing Corporation
FRF = FSLIC Resolution Fund
SAIF = Savings Association Insurance Fund
RTC = Resolution Trust Corporation
REFCORP = Resolution Funding Corporation

[a]Cutoff date for takeovers later extended to June 30, 1995.

[b]Date to cease operations later changed to December 31, 1995.

FSLIC, an amount insufficient to deal with the industry's massive problems.[7]

In response to the deepening crisis, Congress enacted FIRREA on August 9, 1989, beginning the taxpayers' involvement in the resolution of the problem. (See table 2 for a listing of thrift crisis events.) FIRREA abolished the FSLIC and transferred its assets, liabilities, and operations to the newly created FSLIC Resolution Fund (FRF), to be administered by the FDIC. In addition, FIRREA created—to be administered by the FDIC—a new thrift insurance fund named the Savings Association Insurance Fund (SAIF), which would handle thrift failures starting three years from the date of FIRREA. FIRREA also created the RTC to resolve virtually all troubled thrifts placed into conservatorships or receiverships between January 1, 1989, and August 8, 1992. Because of the continuing thrift crisis, however, the RTC's authorization to take over insolvent institutions was twice extended, the second time to June 30, 1995.[8] The RTC was required to cease its operations on December 31, 1995, and transfer any remaining assets and liabilities to the FSLIC Resolution Fund.[9]

FIRREA provided the RTC with $50 billion to resolve failed institutions. Approximately $30 billion of this amount originated through the establishment of the Resolution Funding Corporation (REFCORP), which was a private-public partnership created to issue long-term bonds to the public.[10] The remaining $20 billion came from the U.S. Treasury ($18.8 billion) and the Federal Home Loan Banks ($1.2 billion). Because the $50 billion in initial funding was insufficient to deal with the scope of the problem, Congress enacted subsequent legislation three times, raising total authorized RTC funding for losses to $105 billion between 1989 and 1995. Some of this amount was never used. (See table 3.)

[7] FICO was created by the Competitive Equality Banking Act of 1987 (CEBA) as the vehicle for recapitalizing the insolvent FSLIC. The law authorized FICO to raise funds for the FSLIC by selling bonds to the public; as noted, FICO had $8.2 billion of outstanding debt as of the passage of FIRREA in August 1989. Initially the thrift industry was to be responsible for payment of interest and principal on the outstanding debt. Later FIRREA permitted the FICO bonds to be paid for by annual assessments from the newly created SAIF insurance fund. Because of concern over the low reserves of the SAIF, the Deposit Insurance Funds Act of 1996 (PL 104-208) provided for the SAIF's capitalization. As part of the capitalization effort, future interest payments on the FICO bonds were to be paid for by all FDIC-insured institutions.

[8] FIRREA's original period for the takeover of insolvent institutions was three years, which ended August 8, 1992. The RTC Refinancing, Restructuring and Improvement Act of 1991 extended the period to October 1, 1993. The RTC Completion Act of 1993 extended it through June 30, 1995.

[9] The original RTC termination date, established by FIRREA in August 1989, was December 31, 1996. The RTC Completion Act of 1993 changed the closure date to December 31, 1995.

[10] The 1989 legislation created a quasi-private corporation to provide funds for the RTC. The organization and structure of REFCORP were patterned after FICO, established in 1987 to raise funds for the insolvent FSLIC. REFCORP was authorized to issue debt obligations in an aggregate amount of $30 billion starting in fiscal years 1990 and 1991. The $30 billion in principal on the REFCORP bonds was paid from the sale of non-interest-bearing U.S. Treasury obligations, which REFCORP purchased in amounts approximately equal to the principal of the REFCORP obligations. These zero-coupon securities were funded from the reserves and special assessments of the FHLBs and the SAIF. Funds for the payment of interest on REFCORP obligations came from several sources, including $300 million per year from FHLB contributions and from the U.S. Treasury. REFCORP raised the $30 billion in offerings by January 1991.

Table 3

RTC Funding Legislation

($Billions)

Legislation	Loss Funds	Date of Enactment
FIRREA, 1989	$ 50.1	August 9, 1989
RTC Funding Act of 1991	30.0	March 23, 1991
RTC Refinancing, Restructuring and Improvement Act of 1991	6.7	December 12, 1991
RTC Completion Act of 1993	18.3	December 17, 1993
Total Funds Appropriated	**$105.1**	
Total Funds Provided to RTC	**$ 91.3**	

History of Cost Estimates

Before, during, and even after the RTC's lifetime, estimates of the costs of the crisis created widespread confusion. Federal agencies, politicians, thrift industry experts, and others put forth myriad estimates on what was called the size of the problem. These forecasts often diverged widely and changed frequently in response to surging industry losses. For example, most loss projections for RTC resolutions during the year leading up to passage of FIRREA in 1989 were in the range of $30 billion to $50 billion, but some reached as high as $100 billion at that time.[11] Over the next few years, as a greater-than-expected number of thrifts failed and the resolution costs per failure soared, loss projections escalated. Reflecting the increased number of failures and costs per failure, the official Treasury and RTC projections of the cost of the RTC resolutions rose from $50 billion in August 1989 to a range of $100 billion to $160 billion at the height of the crisis peak in June 1991, a range two to three times as high as the original $50 billion.[12] The fact that the estimates were moving targets increased the public's confusion and compounded Congress's difficulty in reaching a consensus on funding levels for the cleanup.

What accounted for the disparity and volatility among these projections? First, timely information on the condition of the failed institutions was lacking, especially during the early years. Analysts were forced to base their loss predictions on Thrift Financial Report data that were often outdated and unreliable (because thrift examinations had been infrequent and relaxed accounting standards were used at the time). In reality, the industry was in much worse shape than most observers had anticipated, and once the cleanup got under way and the industry came under intense scrutiny, this became apparent. During the asset reviews of insolvent and undercapitalized institutions, it became obvious that the embedded losses were much greater than thrift financial statements had reported.

Another factor was uncertainty about the expected number of future failures. This number was hard to predict because the economy was changing, as were interest rates and commercial real-estate markets. The Bush administration, for example, originally estimated that more than 400 thrifts with over $200 billion in assets would be turned over to the RTC at a cost of approximately $50 billion, but in less than a year the administration's estimate had grown to 700 or 800 thrifts with assets of over $400 billion. The dramatic misreading of the number of failures and subsequent costs of the crisis, especially during the early years, was acknowledged by L. William Seidman, Chairman of both the FDIC and RTC during this era, in his memoir. "Only three months after the cleanup started," he said, "it was already evident that the problem was far worse than anyone in government had envisioned, including me, and it was getting worse every day. The economy was beginning to slide into recession. Real estate was in real depression in some parts of the country, particularly in Texas, where the savings and loan problem was the largest . . . we would also need billions more to pay off depositors and carry weak assets of the institutions until they were sold and we could

[11] The $30 billion to $50 billion estimates formed the basis for the Bush administration plan in February 1989 to provide $50 billion in funding for the cleanup. Experts outside the federal government at that time claimed that the costs could be substantially higher—possibly reaching $100 billion.

[12] During the final year of the cleanup, the Treasury lowered its official estimates to $120 billion.

recover the funds we had invested . . . we were faced with taking the most politically unacceptable action of all, having to admit that we made a big mistake."[13]

A third factor contributing to the disparate and volatile nature of the projections was that some public reports on the size of the problem looked at "apples" and others at "oranges," and the two groups were not comparable. For example, some estimates included only the expected losses from RTC failures but did not incorporate past FSLIC costs. Other estimates included both the FSLIC and RTC losses but focused only on the taxpayers' losses, while excluding losses incurred by the thrift industry over the same period.

One of the most important factors in explaining the variance among the loss estimates was methodological: the total estimated cost sometimes did and sometimes did not include, in addition to the estimated losses, the borrowing costs for the billions of dollars of debt issues floated to fund the cleanup. During the FSLIC and RTC eras, the industry contributed $38.3 billion (sometimes in partnership with the Treasury) in funding for the cleanup. Special government-established financing entities (FICO and REFCORP) raised these funds by selling long-term bonds in the capital markets. The Treasury contributed another $99 billion,[14] some or all of which was also borrowed because the federal government was experiencing large budget deficits during the period. When some analysts tabulated the costs of the cleanup, they included not only the principal borrowed but also interest costs for periods of up to 30 to 40 years on some or all of the borrowings. Including the financing costs in addition to principal could easily double or triple the estimates of the final cost of the cleanup.

However, in our view, including financing costs when tallying the costs of the thrift crisis is methodologically incorrect. It is invalid because, in present-value terms, the amount borrowed is equal to the sum of the interest charges plus debt repayment. Adding the sum of interest payments to the amount borrowed would overstate the true economic cost of resolving the crisis. An example will illustrate the point. Assume an individual pays $100,000 for the purchase of a residential property and finances the whole amount with a 30-year loan at 10 percent interest. Over the 30 years of the loan the individual pays more than $300,000 in total costs, comprising interest and principal. Yet, the cost of the home is still $100,000, because the present value of the total costs of $300,000 for 30 years of payments discounted by the interest rate of 10 percent is approximately $100,000.[15] Another example: the federal government does not include interest charges when costing specific programs, such as weapons systems or school lunches.

Accounting for the Thrift Cleanup Costs

The costs of the thrift crisis are analyzed below in three sections. The first section looks at costs borne by the FSLIC for thrifts that failed from year-end 1985 through August 8, 1989.[16] Funds were provided to the FSLIC, and when the FSLIC was abolished in 1989, the FRF became responsible for paying off notes and other obligations the FSLIC had left behind.[17]

The second section analyzes costs associated with the RTC resolutions of institutions that failed after January 1, 1989 (excluding failures resolved by the FSLIC). These institutions consist of two groups of failed thrifts: (1) those that were nationalized and placed into FDIC-supervised conservatorships from January 1, 1989, through the passage of FIRREA on August 9, 1989,[18] and (2) those that failed after August 8, 1989. In the first group—institutions taken over before August 9, 1989—there were 262 failed thrifts from 33 states, with $104 billion in total assets. In the second group—institutions that failed after August 8, 1989, and before June 30, 1995—there were 485 thrifts with total assets of $290 billion. The third section analyzes total estimated resolution costs.

Table 4 breaks out the thrift crisis losses for both FSLIC- and RTC-related resolutions by source—either the private or the public sector—as of year-end 1999.

[13] Seidman (1993), 208.

[14] Includes $43.5 billion to the FRF and $55.9 billion to the RTC. See table 4. An additional $4.2 billion was provided to the RTC and later returned to the Treasury.

[15] Actually, the total amount paid out over 30 years would be $315,925.

[16] As mentioned above, the tabulation of costs begins in 1986 because that was the year when the FSLIC became insolvent. Its equity was depleted from a positive balance of $4.6 billion on January 1, 1986, to a negative balance of $6.3 billion on December 31, 1986.

[17] FIRREA transferred all of the FSLIC's assets, liabilities, and operations to the newly created FRF to be administered by the FDIC. The funds needed to settle the FSLIC's remaining liabilities were provided by appropriations from the Treasury, industry assessments, and recoveries from asset sales.

[18] Although the failed thrifts were placed into FSLIC conservatorships, an agreement among the FDIC, the FHLBB, and the FSLIC gave the FDIC authority to supervise these conservatorships. In August 1989 at the RTC's inception, the conservatorships were turned over to the RTC for management and ultimate resolution.

Table 4

Estimated Savings and Loan Resolution Cost, 1986–1995

($Billions)

	Private Sector	Public Sector	Total
Direct Cost			
FSLIC/FSLIC Resolution Fund, 1986–95			
FSLIC year-end equity and reserves, 1985	$6.1		$6.1
FSLIC insurance premiums, 1986–89	5.8		5.8
SAIF assessments diverted to FRF, 1989–92	2.0		2.0
FICO bond proceeds, 1987–89	8.2		8.2
FRF appropriations, 1989–95		$43.5	43.5
Less: FRF equity at 12/31/99[a]		(2.5)	(2.5)
Estimated Direct FSLIC/FRF Cost	**$22.0**	**$41.0**	**$63.0**
RTC, 1989–95			
Raised through REFCORP bond proceeds:[b]			
FHLB payments to defease REFCORP debt, 1989–91	1.3		1.3
SAIF assessments paid to defease REFCORP debt, 1990	1.1		1.1
Net present value of FHLB-paid interest on REFCORP bonds[c]	3.5		3.5
Net present value of REFCORP interest paid by U.S. Treasury[d]		24.2	24.2
Total REFCORP bond proceeds	5.9	24.2	30.1
Appropriations from U.S. Treasury[e]		55.9	55.9
Initial contribution from FHLB system	1.2		1.2
Less: RTC equity at 12/31/99[a]		(4.5)	(4.5)
Estimated Direct RTC Cost	**7.1**	**75.6**	**82.7**
Estimated Total Direct Cost	**$29.1**	**$116.5**	**$145.7**
Indirect Cost			
Estimated cost of tax benefits to acquirers from FSLIC assistance		6.3	6.3
Increased interest expense from higher interest rates on REFCORP bonds compared with U.S. Treasury borrowings[f]		1.0	1.0
Estimated Indirect Cost		**7.3**	**7.3**
Estimated Total Cost	**$29.1**	**$123.8**	**$152.9**
Memo: goodwill litigation cost through 12/31/99[g]		0.4	0.4

Note: For these costs to be comparable to those of other government programs, they exclude interest on the national debt incurred to fund the cleanup, and, in the case of FICO and REFCORP, interest that would have accrued to the national debt had such funding come from the general fund of the U.S. Treasury instead of from FICO and REFCORP. Resolution costs start with 1986 because the FSLIC became insolvent that year.

[a]Adjusted for expenses associated with goodwill litigation. See note g below.

[b]REFCORP bonds were funded via a public-private partnership. Total funds raised by REFCORP were $30.1 billion. Because of the mix of private and public funding, discounting is used to allocate the $30.1 billion on the basis of the contributions made by various parties at different times.

[c]Net present value of the FHLBs' $300 million annual contribution to cover part of REFCORP interest expense.

[d]Calculated as the total REFCORP contribution ($30.1 billion) minus the net present value of the private-sector contributions.

[e]Total appropriations were $60 billion, but $4.2 billion was returned to the Treasury in 1999.

[f]Present value of higher interest expense of REFCORP borrowing compared with comparable-term U.S. Treasury securities. This is treated as a public-sector expense because the U.S. Treasury is responsible for all interest expenses above those paid by the FHLBs.

[g]The FDIC cost of litigation stemming from changes in accounting treatment of supervisory goodwill and other items in FIRREA through 12/31/99. The cost borne by the Department of Justice and estimated future costs are unavailable. Awards that have not been paid are excluded. In this presentation, goodwill expenses and recoveries are excluded from the cost of the Savings and Loan resolutions. Goodwill expenses and recoveries relate to legislative changes in FIRREA, not to the resolution of failed thrifts. Thus, this is reported only as a memo item.

FSLIC Estimated Resolution Costs

For FSLIC failures, the loss from the beginning of 1986 forward was $63.0 billion, of which the public sector accounted for $41.0 billion, or 65 percent, while the thrift industry paid $22.0 billion, or 35 percent of the total. All the FRF-related public-sector losses were accounted for by the Treasury's $43.5 billion contribution. As of year-end 1999, however, the FRF still retained $2.5 billion in equity that was expected to be returned to the taxpayers, so the net loss was $41.0 billion.[19] (As mentioned above, the FRF was responsible for settling accounts on all outstanding FSLIC assistance agreements and receiverships.) The $22.0 billion in thrift industry funding for FSLIC losses included: $8.2 billion that came from the thrift industry through the sale of long-term FICO bonds; FSLIC insurance premiums from 1986 forward and SAIF assessments diverted to the FRF, accounting for an additional $7.8 billion in spending; and $6.1 billion from the original FSLIC insurance fund equity and reserves as of year-end 1985.[20]

RTC Estimated Resolution Costs

As of December 31, 1999, the RTC losses for resolving the 747 failed thrifts taken over between January 1, 1989, and June 30, 1995, amounted to an estimated $82.7 billion, of which the public sector accounted for $75.6 billion, or 91 percent, and the private sector accounted for $7.1 billion, or 9 percent (table 4).

The largest component of the public-sector loss was direct Treasury appropriations of $55.9 billion;[21] the Treasury also absorbed $24.2 billion of the $30.1 billion in REFCORP contributions received from 1989 to 1991. However, the public-sector losses were reduced by $4.5 billion in equity held by the RTC as of year-end 1999.[22]

This accumulation of equity over the years was attributable to a number of factors. When an insured depository institution was closed and put into a receivership, the RTC placed a loss adjustment factor against the book value of the assets (this value was based on appraisals or other market information available at the time). These loss reserves reduced the value of the assets to the expected market or recovery value. In its reserving procedures, the RTC (with the approval of the GAO) took a conservative approach so as not to overstate the value of the assets acquired from failed institutions. In applying reserving procedures, the RTC considered a variety of factors including the fair market value of assets when residential and commercial markets were collapsing and the costs associated with particular sales methods developed by the RTC. For example, claims from both representation and warranty guarantees on asset sales and securitizations of nonstandard assets had to be anticipated and loss reserves established. During the 1990s, as the economy improved and real-estate markets recovered, the losses on asset sales and claims from representation and warranty and asset-securitization guarantees were less than anticipated. Thus, a portion of previously set-aside reserves were recaptured into the RTC equity account and offset the overall costs of the cleanup.

The thrift industry losses included the initial $1.2 billion contributed by the Federal Home Loan Banks (FHLBs) to capitalize the REFCORP. The FHLBs also paid $1.3 billion, and the SAIF paid $1.1 billion, to purchase zero-coupon securities worth $30 billion at maturity—to be used to pay the principal of REFCORP debt. The FHLBs incurred an additional $3.5 billion loss that represented the present value of the FHLBs' portion of the interest payments on REFCORP bonds.

Total Estimated Resolution Costs

As of December 31, 1999, total direct costs attributable to the closing of insolvent thrift institutions over the 1986–1995 period amounted to $145.7 billion. Indirect costs due to the loss of Treasury revenue because of the tax benefits that accrued to acquirers of failed institutions under past FSLIC resolutions amounted to $6.3 billion.[23] An additional $1.0 billion of indirect costs was incurred because interest expens-

[19] The FRF equity will be returned to the Treasury as the remaining workload is completed. This figure is adjusted for goodwill litigation costs.

[20] These reserves were premiums paid before 1986 that were spent during the crisis.

[21] Appropriations were $60 billion, but approximately $4.2 billion was returned to the Treasury in 1999.

[22] These funds will be returned to the Treasury, or will be used to reduce the Treasury's interest payments on the REFCORP bonds, as the remaining workload is completed. This figure is adjusted for goodwill litigation costs.

[23] During most of the 1980s, special tax benefits accrued to those acquiring insolvent thrift institutions. For example, assistance paid to acquiring institutions was nontaxable. In addition, in some cases acquiring organizations could carry over certain losses and tax attributes of the troubled institutions to reduce their overall tax liability. These provisions reduced the amount that the FSLIC was required to pay acquiring organizations to take over insolvent institutions. As a consequence of these tax benefits, revenue was lost to the Treasury. Thus, these tax benefits are referred to as "indirect costs." No such benefits were granted after 1988.

es were higher with the use of REFCORP bonds than with Treasury financing.[24] Thus, the combined total for all direct and indirect losses of FSLIC and RTC resolutions was an estimated $152.9 billion. Of this amount, U.S. taxpayer losses amounted to $123.8 billion, or 81 percent of the total costs. The thrift industry losses amounted to $29.1 billion, or 19 percent of the total.

The accumulated losses of $152.9 billion were higher than the official and private forecasts of the late 1980s but lower than those made by the government and others during the early to mid-1990s. As mentioned above, during the late 1980s the full extent of the problem was unknown until the cleanup began; thus, many early forecasts underestimated the size of the problem. In the early to mid-1990s, lower interest rates and an improving economy reduced the number of thrift failures and improved prices for thrift franchises and assets held by thrifts; thus, the final losses were less than those predicted at the height of the crisis. In addition, because perceptions of thrift assets during the crisis years had been unfavorable, the RTC adopted conservative accounting procedures, and the combination of these policies and a strong economy caused the costs of the cleanup to decline every year after 1991.

As of year-end 1999, the savings and loan cleanup was largely complete. The FSLIC Resolution Fund, which controls all remaining assets and liabilities of both the FSLIC and the RTC, either held or had a direct claim on approximately $7 billion in assets, most of which were cash and low-risk securities.[25] Thus, losses from future asset sales will not materially change the loss figures. However, the costs of the goodwill litigation associated with FIRREA (see the Appendix) are still largely unknown, and it could be several more years before these cases are concluded.

Summary

The savings and loan crisis of the 1980s and early 1990s produced the greatest collapse of U.S. financial institutions since the Great Depression. Over the 1986–1995 period, 1,043 thrifts with total assets of over $500 billion failed. The large number of failures overwhelmed the resources of the FSLIC, so U.S. taxpayers were required to back up the commitment extended to insured depositors of the failed institutions. As of December 31, 1999, the thrift crisis had cost taxpayers approximately $124 billion and the thrift industry another $29 billion, for an estimated total loss of approximately $153 billion. The losses were higher than those predicted in the late 1980s, when the RTC was established, but below those forecasted during the early to mid-1990s, at the height of the crisis.

[24] The REFCORP funding mechanism essentially required that the U.S. Treasury pay interest at slightly higher rates than it did for Treasury bonds of similar maturity. Although some might argue that this requirement relates to funding more than to resolution costs, this funding mechanism was considered necessary for Congress to enact the enabling legislation. Further delays in funding would have increased total resolution costs.

[25] Included are $2.9 billion in cash held directly by the FRF, as well as the FRF's claim on $1.5 billion in cash and low-risk securities held by receiverships for which the FRF is the primary creditor.

APPENDIX: GOODWILL LITIGATION

On July 1, 1996, the U.S. Supreme Court ruled that, with the 1989 passage of FIRREA, the federal government had violated contractual obligations.[26] FIRREA mandated new regulatory capital accounting for depository institutions and provided for the elimination or rapid phase-out of the use of "supervisory goodwill" in calculating the regulatory capital of financial institutions. As a result of the Court's ruling, numerous thrifts that had been involved in mergers and acquisitions during the 1980s and had "supervisory goodwill" on their books became undercapitalized. Many of these thrifts were closed by supervisors, while others altered their business strategies (for example, by shrinking their asset base) to meet the new capital standards.

In response, as of July 31, 2000, 141 thrift acquirers had filed suit in District Court or the U.S. Court of Federal Claims, seeking compensation from the federal government for losses (table A.1). As of July 31, 2000, two judgments totaling $40 million had been paid for cases filed in District Court. All other cases were consolidated to the U.S. Court of Federal Claims, where 103 cases were still pending trial. At the U.S. Court of Federal Claims, judgments have been rendered in six cases, awarding the plaintiffs $983 million from the federal government.[27] Four of these cases were on appeal to the U.S. Federal Circuit Court of Appeals; the other two were recent decisions, and appeals are likely. In another five cases, settlements have been reached with plaintiffs receiving approximately $135 million. Another 3 cases had been tried and were awaiting decision; 7 cases had been dismissed; 12 cases had been consolidated with others; and miscellaneous actions have been taken in 3 others.

In cases involving approximately 40 failed thrifts, the FDIC as successor to the closed institutions had become a co-plaintiff in goodwill suits against the United States. Only two of those cases had been decided as of July 31, 2000, and the trial court awarded the FDIC-managed receiverships $19.8 million. All parties appealed one of the decisions, and an appeal of the second decision is expected.

[26] The case was *Winstar Corporation v. United States*, 90-8C; United Savings Bank, Windom, MN.

[27] Most of the $983 million in judgments against the government came from one case: Glendale Federal Bank, FSB, of Glendale, California, was awarded a judgment of $908.9 million.

Table A.1

Status of Goodwill Cases as of July 31, 2000

Case Status	Number	Settlements/ Judgments ($Millions)
Cases with judgments paid[a]	2	$ 40
Cases pending trial	103	
Cases with unpaid judgments	6	983
Cases settled[b]	5	135
Cases tried and awaiting decisions	3	
Cases dismissed	7	
Cases consolidated into others	12	
Other	3	
Total	**141**	**$1,158**

Source: FDIC.

[a]These cases were decided at District Courts. All remaining cases were consolidated to the U.S. Court of Federal Claims.

[b]In one case (Winstar), the Department of Justice settled with the shareholder plaintiff but not with the FDIC. The settlement amount is included here even though the case was pending trial as of July 31, 2000.

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