FINAL TRANSCRIPT

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FRE - Freddie Mac Second Quarter 2007 Financial Results

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Freddie Mac Second Quarter 2007 Financial Results conference call. At this time, all lines are in a listen-only mode. Later, there will be a question and answer session and instructions will be given at that time. (OPERATOR INSTRUCTIONS) As a reminder, today's call is being recorded.

At this time, I would like to turn the conference over to Mr. Ed Golding. Please go ahead, sir.

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Ed Golding - *Freddie Mac - Investor Relations*

Thank you, and good morning. Welcome to our investor presentation and conference call, where we are pleased to present to you our financial results for the second quarter. Speaking today are Freddie Mac's Chairman and Chief Executive Officer, Dick Syron and our chief financial officer, Buddy Piszel. Also joining us for the Q&A portion will be our Executive Vice President and Chief Business Officer, Patti Cook, and our Senior Vice President, Don Bisenius. As we begin, let me make two important points. First, we have posted on our website a slide presentation and core tables, which include additional details of our second quarter results. You may want to have these available, as Buddy walks through them.

Second, please note that today we are making certain forward-looking statements regarding our business results. These statements are based upon a set of judgments and assumptions that are key business drivers and other factors. Changes in these factors could cause our actual results to vary materially from our expectations. You'll find a complete discussion of these factors in today's Information Statement Supplements and the Information Statements in the 2006 Annual Report, which are also posted on our website. We strongly encourage you to carefully review these factors. And one final note, we would like as many people as possible to be able to ask a question. Therefore, if you would please limit yourself to one question and a follow-up, I would be grateful. As time permits, we will come back for a second round. Thanks, and now let me introduce our Chairman and CEO, Dick Syron.

Dick Syron - *Freddie Mac - Chairman, CEO*

Thanks, Ed. Good morning, everyone, and thank you for your time. The second quarter presented Freddie Mac with significant opportunities and challenges, obviously amid an evolving housing and credit environment. As in the first quarter, housing prices declined in many areas. Access to mortgage credit ebbed for some borrowers and credit and mortgage to debt spreads widened. While we achieved improved profitability with net income of $764 million and a fair value increase of $800 million, we were not immune to market forces and we continue to take a cautious view of the housing market.

Now, ironically, while these forces have impacted our near-term profitability, over the longer run, the likely return to more level -- to more reasonable levels of risk pricing will obviously benefit us. In the second quarter, Freddie Mac's net interest income stabilized, our guarantee income grew, our mission value became very visible and our shareholder value increased. There's no doubt that our quarterly data continues to be extremely bumpy, but it's also clear that our forward-looking opportunities to deploy capital effectively in the business look good. In addition, we continue to accelerate our financial reporting by releasing results two weeks faster than in the last quarter.

Throughout the long housing market boom, mortgage industry participants were largely protected from credit risk by significant annual house price gains. Today, we expect nominal house prices to be flat to slightly negative this year and next and are preparing to conduct business in that environment.

While I was an early bear on the housing market, I was not bearish enough giving the degree to which housing prices were outstripping income growth. In contrast, I do think some of the most negative forecasts out there today are too severe and that many of the recent problems will be worked off in the next 18 months or so, as in the neighborhood of 1.5 million additional households will be formed to take up some of the current inventory overhang. Over the next decade, we expect this growth in demand to total about 13 to 15 million households. So as long as liquidity is provided to the housing market, this cycle will be manageable for adequately capitalized companies. It will, however, place ever more of a premium on the quality of our credit underwriting process and the strength of our customer relationships. Throughout the second quarter, we have grown our guarantee volumes by an annualized rate of about 15 percent as higher fixed rate production and opportunistic growth amid market dislocations have improved our share of the total conforming market.

We have achieved this growth, while maintaining a disciplined approach to achieving attractive mortgage asset to guarantee spreads. In particular, we have done this in our expanded bulk purchase activities, an area where we can more closely tailor rates to the risks we undertake and promote stability by doing so in the U.S. mortgage market, and by modifying also the terms

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of business in our flow contracts. Importantly, we have also taken steps to fulfill our mission and exert leadership, by insisting on improved underwriting standards for subprime mortgages. It seems like a long time ago, but in February, we became the first major secondary market participant to announce that we would no longer buy subprime loans that posed an unacceptable risk of excessive payment shock and possible foreclosure. In April, we followed up by announcing we would purchase up to $20 million in fixed rate and hybrid ARM products in the subprime space that, are being developed to limit payment shock and provide lenders with more and safer choices. I'm pleased to report that in July, we settled our first purchase of subprime mortgage under this new guideline and we are witnessing a significant shift in production volumes towards products that we feel offer sustainable options for homeowners and attractive values for our shareholders at the same time.

The events of the last two months have also highlighted the need for smooth and uninterrupted liquidity flows in the mortgage market. We have also committed to purchase Alt-A products that fall within our credit box on a 90-day forward basis. This program provides stability and certainty of execution for our originators. It is one more way that Freddie Mac is providing liquidity and stability in a tumultuous market. We're far from the total answer, but we're doing everything we can to help the markets and homeowners, and we want to maximize our ability to do even more in the future. The various steps we are taking clearly foster our congressional charter and public mission. We are confident they also serve our business objectives.

As you know, we are still operating under our voluntary temporary portfolio growth limit and we do have some dry powder left, but we're constrained from playing a fuller role in stabilizing the market, as long as we are subject to portfolio limits and capital surpluses. There is still a need in our mind for long-term committed investment from the mortgage market that will help the growing inventory of assets to clear. Freddie can help fill this role, and in fact, that's what we're designed for. As is appropriate, we are discussing these issues on an ongoing basis with our regulators. So those are the headlines: a return to profitability, very tangible execution of our mission in a tough time, improved controls and accelerated financial reporting. And this all happened in a decent quarter and with a strong platform to build on. With that, let me turn things over to our Chief Financial Officer, Buddy Piszel.

Buddy Piszel - *Freddie Mac - CFO*

Thanks, Dick, and good morning, everyone. I'm going to take a few minutes to provide a high level review of our second quarter 2007 financial results and current business trends. We posted a package of slides that I'll refer to in my remarks, but given the current market environment, let me first give you a summary of where we stand on credit risk. We have provided you with a much expanded view of credit data that focuses on the riskier portions of our portfolio. A few take-a ways, one, our overall exposure to higher-risk products is low relative to our competition. Two, we have limited -- we have a limited and a manageable exposure to all day and risk-layered products, such as loans with both high LTV and low FICO scores. Three, delinquencies are low, but they are trending upward, particularly in California and Florida. And finally, our overall credit profile equips us to weather this downturn better than other market participants.

I'll briefly discuss the delinquency data and the exposure to risk-layered products, which are in the disclosures, and then I'll make a comment on our counter-party credit risks. First, delinquencies. While our single-family portfolio delinquency rates remain very low, we are seeing some regional increases. Over the past couple years, much of this experience is reflected economic weakness in Michigan and Ohio. More recently, the biggest changes come from California and Florida, where house price declines have led to sequential quarter increases in delinquencies of about 30 percent. Consistent with this recent deterioration, loans supporting 2006 PCs have exhibited significantly higher early delinquency rates through their first 18 months certainly than we experienced in recent years. For example, the 2006 serious delinquencies are approximately double the average we experienced in the 2000 to 2005 books. This is in part, driven by the weaker house price path and a higher percentage of loans that have secondary financing.

On mortgage product concentrations, we have low exposure to all day and risk-layered loans, and when taken together, these represent about 8 percent of the total single-family guarantee portfolio. On the Alt-A side, as of the end of June, we guaranteed $120 billion of loans that were either identified by the originator as Alt-A or had reduced levels of documentation. Importantly,

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we have been able to price for this higher risk, because we source most of these loans through bulk purchases. In addition, for the Alt-A book, we have significant credit enhancement, strong average current LTVs of 71%, and FICO scores of 715. These attributes should limit the credit impact from these loans. As to risk-layered products with low FICOs and high LTVs, at the end of the second quarter, we had total guarantees of about $10 billion, or less than 1% of our portfolio, and nearly all of this had credit enhancement.

Lastly, let me give you my views on counterparty credit risk. We believe we manage this very well. In periods like this, we're even more vigilant on these risks. We analyze and stress test a lot of detailed information in order to better anticipate and monitor potential deterioration in the credit quality of mortgage insurers and the seller services that we do business with.

Our evaluation of the MIs is that they are adequately capitalized. While some of them may fare better than others in the current market, in the long term we're comfortable with our position. On the seller servicer side, we maintain a comprehensive watch list for those companies where we believe risks are elevated and take risk reduction actions to lower our exposures. Over the last nine months, some of our servicers have run into trouble, but we have taken the appropriate steps and have not incurred any material losses. In addition, in the event of a significant disruption, we have provisions to protect our risk positions and ensure servicing by capable counterparties. When we put all this together on the credit front, from a regional exposure, product concentration and counterparty credit risk perspective, we are well positioned in the current environment.

With that, let me now turn to the second quarter results. As we announced this morning, Freddie Mac earned net income of $764 million in the second quarter, down from $1.4 billion a year ago. On a pre-tax basis, practically all of this decline resulted from an increase of $592 million in credit-related expenses and credit-related mark-to-market items. Outside of credit, many aspects of the business improved. Net interest income and margins stabilized sequentially. Management and guarantee fee income continued its good growth rate. Our interest-rate risk metrics remain very low. We continue to improve our internal control environments in several areas, and as Dick noted, we have accelerated our financial reporting timeline by two weeks over last quarter.

With that, let's turn to the GAAP results shown on slide two. And let me start with net interest income. Line one shows that we had a reduction in net interest income of $199 million compared to the second quarter of 2006. As we discussed in June, our net interest margin declined throughout last year, as the flattening of the yield curve and replacement of the significant amounts of lower yielding and long-term debt reduced our GAAP margin. Since this activity occurred throughout 2006, we are still seeing the effect in our year-over-year comparisons. If you look at NIM compared to the first quarter of 2007, you can see that it's stabilized. This has occurred as debt refinancings have slowed. Our portfolio grew. The mix shifted towards fixed rate assets, and the yield curve steepened. Moving to the guarantee business shown on line two, year-over-year management and guarantee income increased by $85 million to $474 million, as improved customer volumes and higher contractual guarantee fee rates improved our results. Thus far in 2007, we have grown our guarantee portfolio significantly, as shifting origination patterns back towards fixed rate mortgages and increased bulk purchase transactions have boosted our total market share and top line g-fees.

Turning to expenses, line six, shows that administrative expenses increased by $37 million to $442 million, as we continued making investments that have accelerated our financial reporting time line and allowed us to make good progress on fixing our internal controls. As we're now about two-thirds of the way through 2007, we're better positioned to give guidance on our full-year costs, and we would expect to end the year with administrative costs of about $1.7 billion, or an increase of roughly $100 million over our 2006 levels. Given that total admin was up from the '06 levels, year-over-year will be basically flat, at about 9.2 basis points as a percentage of our total mortgage portfolio. Make no mistake, though, there is leverage in our business model and over time, this ratio of total administrative expenses will decline. Over the long-term, we believe that we should be able to reduce administrative expenses on an absolute basis and you should start seeing some of that in 2008, once we complete some of the financial remediation and start the benefits of our new technology investments.

Finally, line seven shows credit-related expenses, which included our provision and REO expenses increased $336 million. We recognized this expense in response to deteriorating house price environment, higher delinquency to foreclosure transition

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rates and increased average UPB levels in the 2006 and 2007 books. On the basis of total credit costs, and that I'll define as charge-offs plus REO expense, we realized $79 million of credit loss in the second quarter, or two basis points of our total managed portfolio. That's up from 1.3 basis points a year ago. Now, given the current credit trends, we would expect full year 2007 credit losses to increase, but to come in at less than three basis points. A level that is below our historical average of five. This positions us well in a market that has not yet hit bottom and as such, we would expect the 2008 credit losses on this basis to increase from the 2007 levels.

Let me now take you through the GAAP mark-to-market items on slide three, since they have continued to be volatile. Line 10 shows the total mark-to-market impact in the second quarter was a gain of $430 million. I should note that unlike previous periods, the mark-to-market effects of our portfolio of derivatives had a relatively small impact on the results. Rather, most of these gains resulted from the changes in the fair value of our guarantee asset, shown on line two, which recorded an increase of $1.1 billion. As we indicated in June, higher long-term interest rates in the second quarter caused the GA to increase in value. Moving down to line eight, increased market concerns over mortgage credit risk produced mark-to-market losses of $392 million in the quarter. These marks were largely associated with increased market discounts on the delinquent loans we buy out of PCs and higher market implied default costs on certain pool purchases underlying new securitization.

Just a reminder, we use market-based prices in valuing these items and in times of stress, these prices can overshoot the actual risks. Accordingly, these marks imply higher future default costs than we ultimately expect to incur. Nevertheless, given the recent credit market deterioration, we have witnessed through July and August, it is likely that we'll report significant mark-to-market losses on these items in our third quarter GAAP results.

Turning to fair value, on slide four, fair value of net assets increased by about $800 million in the second quarter, as gains on the fair value of the guaranteed asset and the underlying returns generated from investments and guarantee activities more than offset losses due to mortgage-to-debt OAS widening. As you can see in line one, investment activities in our retained portfolio reduced fair value by about $800 million in the second quarter, as compared to an increase of about $1 billion a year ago. Line two shows that most of the year-over-year decline is related to widening in the mortgage-to-debt option adjusted spreads. Aside from this reduction, fair value returns in the retained portfolio have remained solid, as core spread income has increased year-over-year, as a result of wider OASs and new portfolio purchases. In our guarantee activity, shown in line three, the change in fair value was a positive $1.8 billion in the second quarter compared to a gain of about $1.2 billion a year ago. Notwithstanding the interest rate and credit-related marks on lines four and five, underlying results in the business improved year-over-year due to increased customer volumes and moderately higher total guarantee fees. Again, given the market turmoil in July and August, with both OASs and credit spreads gapping out wider, unless market conditions change, we would expect to record a significant reduction in fair value in the third quarter related to these items.

I'll close by discussing our progress on our capital management, financial reporting and internal controls. First, capital. Following the release of our 2006 financials, we initiated our preferred-for-common swap under our $1 billion authorization. Through the end of the second quarter, we bought back $750 million in common shares, and issued $500 million in preferred stock. During the third quarter, we repurchased the remaining $250 million under the common stock plan and issued an additional $500 million of preferred. Given the current level of spreads in the market and profitable growth opportunities in both our guaranteed business and our investment area, we are balancing capital returns with our ability to invest in the business in ways that provide attractive long-term returns. It's important to note that we have a very good ability to source additional capital, should we need it to fund profitable growth.

On a control front and timeline, let me make a couple points. First, with today's release in 61 days, we have meaningfully accelerated our financial release process. As a reminder, our target for the third quarter was 60 days, so we're basically a quarter ahead of schedule. Given the success and our commitment to continue to improve with each release, we are targeting the release of the third quarter results by Thanksgiving. That would represent a further improvement of 10 days.

Second, as we've just advanced the timeliness of our financial reporting, we are also making progress on new and more understandable results presentation. I would expect to roll that out with a full set of presentation and disclosures in early 2008

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in anticipation of SEC registration. Lastly, in this quarter, we've addressed two more significant deficiencies in our financial reporting process. The first related to tightening of our GAAP policies and the second related to improved oversight of our financial and business models. So we are making very good progress on our overall remaining issues, and I'm optimistic that we will have the bulk of our control issues behind us by year-end. With that, let me turn it back to Dick.

Dick Syron - *Freddie Mac - Chairman, CEO*

Thanks, Buddy. Let me make three points and then get to your questions. First, we've told you in previous calls that the underlying economics of our business matter more than the swings due to accounting. We think today's call confirms the enduring strength of our core franchise. It's worth keeping that in mind, as we move forward, particularly in the current environment. Second, we've set forth in prior calls the investment thesis that Freddie is a very sound way to participate in the long-term growth of housing in this country. To the extent this environment, which I think it does, say this company is built for the long run, we believe it plays to our demonstrated strengths.

Finally, we all know that Freddie is easy to take for granted when times are good, but our value becomes very clear when the market runs into trouble. That is exactly what's happened again. The housing finance system almost immediately recognized this and to an increasing extent, the political and regulatory system has been facing that fact as well. We're doing everything we can today to help the market and homeowners and we want to maximize our ability to do even more.

The genius of the GSE model is that by doing more for our mission at a time like this, we don't detract from our shareholders, in fact, we help them. We serve both our mission and our shareholders. And with that, let me now ask to turn to questions.

QUESTIONS AND ANSWERS

Operator

Great. Thank you very much. (OPERATOR INSTRUCTIONS) And our first question then today comes from the line of Paul Miller with FBR Capital Markets. Please go ahead.

Paul Miller - *Friedman Billings Ramsey - Analyst*

Thank you very much. And my question has to do with the MI companies. One of the things that's happened over the last three months is that the MI companies have come under risk of being downgraded from their double A status to their single A status. And these guys provide a lot of reinsurance support for a lot of the loans above 80% LTV in your guys' portfolios. What is the contingency plan if a bulk of these guys, like a Radian or Triad gets downgraded to single A. Can they still write business for you? And if they can't, is there enough capital in the MI space to continue with writing loans in the 80% LTV levels, or would you have to back off on taking some of those loans?

Patti Cook - *Freddie Mac - EVP, CBO*

Hi, Paul. This is Patti Cook. I'll respond to the question. We continue to believe that the MIs are well capitalized. So despite a potential rating decline for that industry, we look at the institutions closely and in every case we think they are adequately capitalized for the book of business that we have on with them at this time and that we would expect to do in the future.

Paul Miller - *Friedman Billings Ramsey - Analyst*

So, even if they got downgraded to single A, that really wouldn't interrupt the business flow?

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Patti Cook - *Freddie Mac - EVP, CBO*

No, it wouldn't.

Paul Miller - *Friedman Billings Ramsey - Analyst*

Okay. Thank you very much.

Operator

Thank you. And we have a question now from the line of David Hochstim with Bear, Stearns. Please go ahead.

David Hochstim - *Bear, Stearns - Analyst*

Yes, hi, thanks. I wonder, Buddy, maybe could you provide a little more color on how to think about the increase in the loss revision and the building of reserves, with so far the very modest increase in single-family charge-offs and modest, somewhat modest increase in overall credit losses? And then the mark-to-market adjustments on the repurchase loans and how one can think about what your true credit loss exposure is on all that.

Buddy Piszel - *Freddie Mac - CFO*

Okay. In the first quarter, David, we increased our reserves up - we took a provision for $191 million, and we said at the time that a lot of that was due to our early experience on the '06 book. When we started the '07 year, we got into the first quarter of '07 - we were thinking the '07 book was going to look more like the average of a couple of years versus the '06 book. And the early read now, as we look at the credit quality of what we've originated, plus the very, very early read on delinquencies, is that '07 looks a little bit more like '06. So we prudently have booked up our reserves in the second quarter, a little bit of catch-up on the '07 book and then a continued reflection of where we see the '06 book going. So that gives you some color for where the provision is. When we think about the way to look at this, because there is a big difference between where the provision is and where the charge-offs are.

And the charge-offs, two points there. One, the provision only covers the off-balance sheet exposure, so it's not the full picture. The charge-offs, however, are the full picture and they are the most all-in indicator of where our actual credit losses have settled down. After the mark-to-market items, we take that in two places. One is when we repurchase loans out of the PC pools that are more than 120 days delinquent and pricing has gotten worse with every sequential quarter, and I think the - we call these LIA loans. These loans are now at prices that are in the 70s range compared to when we started the year in the high 90s, it deteriorated to 80s in the first quarter. It's now into the 70s, and that's creating some exacerbation of the reported losses that were reflecting there. Likewise, when we're purchasing secure - when we're issuing securities, certainly the pools may have losses embedded in them if you use the market view of potential default costs. And again, that's gone up in the second quarter really because of the market's view of where default costs are and both of these could be a reaction. But we'll have to see when that settles out.

David Hochstim - *Bear, Stearns - Analyst*

Okay. When you finally realize the actual losses, what happens? You would have an offset or recovery against those expense items in future periods?

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Buddy Piszel - *Freddie Mac - CFO*

Right. Exactly. You'll have a recovery the fair value side and the real loss will ultimately find its way through the charge-off line.

David Hochstim - *Bear, Stearns - Analyst*

Okay.

Buddy Piszel - *Freddie Mac - CFO*

So at the end of the day, everything goes through the charge-off line.

David Hochstim - *Bear, Stearns - Analyst*

Okay, thank you.

Operator

Thanks. And we have a question now from the line of Fred Cannon with KBW. Please go ahead.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

Great, and thank you. I just wanted to follow up on the comments on current market conditions on fair value. The comments were quite cautionary and I just wondered if we could get a bit more color. I believe the increase in OAS would have a negative impact on the investment activities and deteriorating credit would have a negative aspect on the fair value of the GO. I was wondering about current market conditions on GAs. Would that also be a net negative given what's occurred since the end of the quarter?

Buddy Piszel - *Freddie Mac - CFO*

Yes, interestingly, we had an increase in GA in the second quarter because rates were going up. With the rates rallying in the third quarter, that would be another negative. So it's a little bit like a triple - triple storm.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

Triple storm, okay. And so the issue on rates on the GA is driven by treasuries rather than the mortgage market rates, is that right?

Buddy Piszel - *Freddie Mac - CFO*

And the spreads. And spreads, but you're generally correct.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

Okay, great. Thank you very much.

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Operator

Thanks. And we have a question now from the line of Bruce Harting with Lehman Brothers. Please go ahead.

Bruce Harting - *Lehman Brothers - Analyst*

Yes, I wasn't totally clear on the answer to David's question about the - sort of the eight-basis point provision rate versus the two-basis point charge-off in the quarter. So what you're saying is that the provisioning level in this quarter anything near - should we expect that to be a run rate? And I know you're getting out ahead of arising delinquencies or transition rates and higher severity, but can you give any further guidance? I think you said in your prepared remarks this year might be going more towards like three basis points and next year higher. If you could firm that up any more, that would be great. Thanks.

Buddy Piszel - *Freddie Mac - CFO*

Couple points, Bruce. There is an element of catch-up in the second quarter provision for first quarter '07 book. And that's in the zone of about $60 million. As to the balance of the year, I wouldn't be surprised if our provisioning stays at about the first half level, but it depends on what we're seeing in the '06 and '07 books is really just a draw-forward of losses versus a likely increase in the overall tail. So we'll be watching that carefully. When we think about the provision, the provision covers about 2.5 years of losses, so there is a built-in lag in the way this will emerge, and we'll just see how things emerge on the overall credit story. But that gives you some more color. I don't know if there's anything more that we can share with you.

Dick Syron - *Freddie Mac - Chairman, CEO*

Bruce. This is Dick. Just let me add in a color sense to this - when we look at the likely evolution of the housing market and the economy, we have elected to be on the cautious, or bearish side of that, feeling that it is better for us to err in that direction than making our estimates in the other direction.

Bruce Harting - *Lehman Brothers - Analyst*

Great, thank you.

Operator

And we have a question now from Bob Napoli with Piper Jaffray. Please go ahead.

Bob Napoli - *Piper Jaffray - Analyst*

Thank you. Good morning. I would like to take the - maybe the MI question maybe theoretically a little bit further, and I understand your view that they are well capitalized. The stock market isn't agreeing with you at the moment. And just theoretically, if the one or two of the MIs were to have ongoing problems and we're not able to meet their obligation, can you maybe just walk through what you think the exposure would be to Freddie Mac and how that might work?

Don Bisenius - *Freddie Mac - SVP*

This is Don Bisenius. One of the ways we think about our MI exposure is we look at the amount of product that's actually covered and what types of losses could be experienced in a stress-type scenario. When we run those scenarios, we find that the amount

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of capital, as well as future premium income that the MIs earned is more than adequate to cover the exposure that we have there. So even if there is some downgrades and things like that, their existing capacity to cover the losses they have to us is more than adequate.

Bob Napoli - *Piper Jaffray - Analyst*

But if they were not, then is there an insurance fund that makes up the difference, or is it, does that come onto the GSEs?

Don Bisenius - *Freddie Mac - SVP*

I'm not sure - there is the capital that the insurance companies have themselves that we believe is more than adequate to cover it. In the event you got into a particularly stressful environment, there is also the future earnings capacity on the premiums on those books that can be used to offset losses.

Bob Napoli - *Piper Jaffray - Analyst*

Thank you.

Operator

Thanks, and we have a question now from the line of Brad Ball with Citigroup. Please go ahead.

Brad Ball - *Citigroup Global Markets - Analyst*

Thanks. Buddy, you mentioned a couple of times the likely negative impact of current market conditions on the mark-to-market and fair value results for the third quarter. I wonder if you could talk about what are, if any, are the fundamental implications of that. What are the implications for your capital and your regulatory capital adequacy, but perhaps more importantly, and maybe Patti could chime in, what are the implications for the OAS and your g-fee rates? And I wonder if you could give a little more color on what you're seeing on the bulk side in g-fees. Thanks.

Buddy Piszel - *Freddie Mac - CFO*

Let me take the capital question first. Brad, we have projected out where our capital could be on any kind of a stress scenario through the balance of the year, and we feel that we're adequately capitalized, and we have actions that we can take on the balance sheet to be able to continue our growth rates in the g-fee business and grow our retained portfolio to the cap. So we're not concerned at this point. It will be a negative, but it's a manageable negative to our overall GAAP capital, as we've currently estimated it.

Patti Cook - *Freddie Mac - EVP, CBO*

Brad, you raise the right issue, which is always at first blush a little confusing. When you look at the retained portfolio and you see a substantial draw down in fair value, because OAS has widened, you flip that around and you look at the opportunity that it creates for us to purchase. It's also important to remember that as we mark the portfolio down, because OASs have widened, we earn that back over time in a higher OAS or accrual rate on the portfolio going forward.

So if you look at the total mark-to-market loss we've realized in the retained portfolio for the first six months of the year, that's translating into 20-plus basis points of higher OAS in the portfolio going forward. I think as it relates to bulk g-fees, which you

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also referenced, you're also raising an interesting point, which is the difference between our capacity to respond to the market changes in bulk space versus flow space. In bulk space, which operates as a spot market, if you will, as prices change, we can change the price that we bid for those portfolios. On the other hand, within flow space, it's more difficult. While we do have some delivery fees, the risk-based pricing aspect of flow is not nearly as good as it is in bulk.

Brad Ball - *Citigroup Global Markets - Analyst*

Thanks.

Operator

Thank you, and we have a question now from the line of Howard Shapiro with Fox-Pitt. Please go ahead.

Howard Shapiro - *Fox-Pitt Kelton - Analyst*

Hi, wanted to ask you, I guess, another question on your fair value methodology. I understand that we are going to see a decline in fair value next quarter due to wider spreads. Can you, I guess the question really is to Patti, tell us how much of your valuation methodology is model-driven, how much is market-driven, and in the market environment like we have now, where there's - it's basically liquid and not very much price discovery, how exactly do you depend on the market to drive valuation?

Patti Cook - *Freddie Mac - EVP, CBO*

Alright. Great question. On both our g-fee business and on the retained portfolio, we use market-based pricing to mark those portfolios to market. On the retained portfolio side, since the vast majority, basically everything we own, is quite liquid, we are not seeing any issues, if you will, in getting prices on that part of the portfolio. On the g-fee business I think there the possibility for continued wider spreads in this particular market exists for that book to continue to get marked down. So in both cases, it's a credit environment that exists today persists, risk premiums are high. Both those books could get - could continue to be marked down. But I want to make a couple of observations. The way to think about the cumulative mark on the retained portfolio is that you then have a higher accrual rate, if you will, that you weren't in your core spread going forward. The way to think of it on the credit guarantee business is a little different. If you look at the accumulated mark in GO, one way to think about it is what is the implied house priced path that would justify that kind of mark in GO? And I think that we would say as of today, even through August, that the implied house price path in our GO mark-to-market is more severe than any that we are likely to realize.

Howard Shapiro - *Fox-Pitt Kelton - Analyst*

Okay, and just one follow-up, on the portfolio limits. Your letter to OFHEO clearly states that in an environment where there's a liquidity issue, you would no longer be bound by the voluntary cap. If there's ever an environment that calls for corporate statesmanship, it seems like this is the environment. I'm a little surprised and perhaps you could explain to us why you haven't chosen to be more active and grow your portfolio in this crisis situation.

Dick Syron - *Freddie Mac - Chairman, CEO*

Well, this is Dick. Two or three observations. First, we are growing our portfolio and we're trying to do things judiciously so that we have the greatest impact obviously jointly on our mission objectives and on shareholders. Second observation is that we are in continuous discussions with our regulator, as are other people, about what will happen with the caps and the outcome there is yet to be determined. But the interpretation of our regulator so far, and I think we may disagree on the term voluntary

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to some extent, is that the caps are binding at this point in time. That has to be resolved. I think the regulator is examining what's going happen with the caps, and we don't think, as I've said before, that in this immediate environment, it's advisable for our shareholders to get into a protracted conflicts with our regulator.

Howard Shapiro - *Fox-Pitt Kelton - Analyst*

Thank you.

Operator

Thanks. And our next question comes from the line of Moshe Orenbuch with Credit Suisse.

Moshe Orenbuch - *Credit Suisse - Analyst*

Yes, sort of just a follow-up on that comment and a couple of others. I mean, I think the fact the company has $1.8 billion of excess capital at June 30, sounds like on a GAAP basis you probably swing back to a loss in the third quarter. It was a reference made to capital available to you. I guess, I just want to understand that whole concept of, as to how you take advantage of this current environment if in fact the capital seems to be a bit constrained, and reference that and kind of combine it with the fact that your commitments at the end of July were down over 90%.

Dick Syron - *Freddie Mac - Chairman, CEO*

Well, first, let me just start this. First of all, we do have a surplus in this period. Second, on the - on the 30 percent surplus issue, when that arrangement was first contemplated, it was contemplated on a basis, which I think makes sense for most things in life, that it wouldn't be a death trigger, but rather it would be something that would be considered over an averaging period. We're having some discussions with our regulator on that, and there are a variety of mechanisms that could be employed to give us more space, which we think would be desirable obviously not only from our perspective, but from the perspective of the markets.

Patti Cook - *Freddie Mac - EVP, CBO*

I just want to address what we are doing within the constraints of the cap. And I think you've got to look at us providing liquidity to market in two fundamental ways, both on the sort of prime side and the primary market and the secondary market. In the primary market, we are trying to provide liquidity via the subprime model offering and also our more recent disclosure on Alt-A, where we'll commit to up to 90 days for a particular credit box. So both of those activities are a way to continue to provide liquidity. I think in the retained portfolio, where the cap is an issue, we are trying to optimize our purchases, both against the cap and again run-off. So when you look at the monthly run-off in our portfolio of $12 billion to $15 billion a month, we are trying to be very selective and optimize where the market could use the redeployment of that liquidity, if you will, most advantageously. And for us right now, that's going to be a combination of agency pass-throughs, when they need it, which is the case in June, where you saw $40 billion of commitments, but then also supporting the non-agency aspect as a secondary market. So I think it's important to remember that we do have a fair amount of run-off, that we can optimize against, as well as up against the cap.

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Dick Syron - *Freddie Mac - Chairman, CEO*

Moshe, the reason we said that the way we did, if the cap were lifted and we were given no relief on the mandatory 30 percent, we would consider issuing preferred to take advantage of our unlimited portfolio of market conditions to say we could make money by doing it.

Moshe Orenbuch - *Credit Suisse - Analyst*

Did you ask OFHEO specifically?

Dick Syron - *Freddie Mac - Chairman, CEO*

We don't have to ask them to issue preferred stock. We only -

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Moshe Orenbuch - *Credit Suisse - Analyst*

No, no, I'm talking about on the cap. There were press reports that Fannie Mae asked for an increase so - that didn't seem comparable.

Dick Syron - *Freddie Mac - Chairman, CEO*

We have made clear - we did not - we were not involved in the exchange of letters, but we have made clear in numerous venues, as we're making clear now, that we think from a public policy perspective, there would be a benefit for lifting both the caps and the $417,000 limit on what we can buy, obviously given the disruptions in the jumbo market, and we are in continuous discussions with our regulator on that process.

Moshe Orenbuch - *Credit Suisse - Analyst*

Thanks.

Operator

Thank you. And we have a question - a follow-up question from the line of David Hochstim with Bear, Stearns. Please go ahead.

David Hochstim - *Bear, Stearns - Analyst*

Yes, hi, actually two parts. Buddy, you were talking before about poorer performance in the 2007 book than you had anticipated. Is it possibly you really haven't seen a lot of 2007 production, and that what's been called 2007 so far in the early part of the year was really flopping over from '06?

Buddy Piszel - *Freddie Mac - CFO*

That clearly is the case, and we're going through analyzing right now exactly how much of '07 is '07 originations versus '06 spillover. So that is the case. What we're reacting to is not so much the early read on the performance of the book, but really the attributes of the book, which look a lot like '06, but that makes sense, since a lot of it was originated in '06.

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David Hochstim - *Bear, Stearns - Analyst*

And then the follow-up I had is for Patti. If you could just give us maybe some additional color on what you're seeing today and the end of August or the beginning of September in terms of opportunities or relative spreads without being too specific in disposing what you really plan to do. But are there opportunities to, to maybe more aggressively sell some assets and then buy others, if you're seeing $0.70 prices on certain assets now, wouldn't those be things that would be a lot - in some cases - more attractive than some of the PCs you've got?

Patti Cook - *Freddie Mac - EVP, CBO*

Yes, I think we have, and have already exercised the opportunity to be able to sell when the market corrects. And the way we think about the products area, you've got the very liquid TBAs, you've got less liquid agencies and then you've got non-agencies. And really trying to maximize the impact we have on the market through both sales and purchases, is clearly something we're trying to do.

David Hochstim - *Bear, Stearns - Analyst*

Can you give us a sense of the relative change in OAS, or maybe even tell us what you think OAS averaged on the portfolio in the second quarter?

Patti Cook - *Freddie Mac - EVP, CBO*

What I would do is take the mark-to-market loss that we disclosed to you in OAS for the first two quarters and look at that on the overall portfolio and you'll see that spreads have widened on the portfolio by 20 to 25 basis points. And if you think about the portfolio as being somewhat representative of the assets we can purchase, it's telling you something about the opportunity, although obviously it is a distribution around that 25 basis points of widening.

David Hochstim - *Bear, Stearns - Analyst*

Okay. Thank you.

Patti Cook - *Freddie Mac - EVP, CBO*

Is that helpful?

David Hochstim - *Bear, Stearns - Analyst*

A little bit, yes, thanks.

Operator

Thanks. We have a question, I'm sorry. We have a question from the line of Bruce Harting with Lehman Brothers. Please go ahead.

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Bruce Harting - *Lehman Brothers - Analyst*

Yes, in the event that number of economists now are looking for a couple of studies between now and the end of the year, do you have any data on the coupon distribution that could be helpful in our understanding of the speed with which 50, 75 or 100 basis points would - what impact that would have in terms of refi volumes and would it be - would it actually be helpful to your efforts in the subprime remediation in terms of moving some of those resets into fixed? So any help you can be in terms of that data. And then, Buddy, you talked about the margin having stabilized and gave a number of reasons that you listed, mix shift, steeper curve, etc. I wondered if you could just go through each of those factors as you see them impacting the margin for the next six to 12 months. Thanks.

Patti Cook - *Freddie Mac - EVP, CBO*

First of all, on your economic outlook and the likelihood, or the result of fed easing, I think you would have to look at that as a positive for the underpinnings of the mortgage market overall. So I think you're on sort of the right path to think about would it make it easier for current subprime borrowers to refinance into a fixed. And I haven't really thought about what that would do to volumes, but, yes, I think at the end of the day that would certainly be helpful.

Buddy Piszel - *Freddie Mac - CFO*

Add to the factors that are stabilizing NIM, most of what contributed to NIM stabilizing in the first quarter should continue for the balance of the year. I think the shift to fixed rate product, we see that continuing. The - your guess is as good as mine what's going to happen with the yield curve. But the one item that may be - or the amortization of the deferred cash flow hedge is stable for the entire year, so you're not going have the higher levels that we experienced in 2006. The one wild card, what happens with rates, because in the second quarter, we've got a little bit of positive lift from rates being up and the premium amortization was reduced as a result of that. That could move around $50 million or so, but it's not a big driver. So our sense is that we should continue to see a stabilization of NIM over the balance of the year, and if the book continues to grow, you would expect to see some growth there, too.

Patti Cook - *Freddie Mac - EVP, CBO*

I might add to that, the other underlying fundamental is that the economic margin and the business is improving and over time, that will play through, or should, NIM.

Operator

Great, thank you. And we have a question then from the line of Paul Miller with FDR Capital Markets. Please go ahead.

Paul Miller - *Friedman Billings Ramsey - Analyst*

Hi. Yes, I just had a quick follow up on the MI question again. You said it doesn't really matter if they get downgraded to single A if you allow them the right business, but does it impact your risk-based ratios at all? Because I remember way back when there was a discussion between holding different capital levels between triple As and double As, and that got waived. Is there - are there different capital levels between a single A underwriter versus a double A underwriter?

Patti Cook - *Freddie Mac - EVP, CBO*

Small difference in the capital charge.

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Paul Miller - *Friedman Billings Ramsey - Analyst*

Small difference?

Patti Cook - *Freddie Mac - EVP, CBO*

Yes.

Paul Miller - *Friedman Billings Ramsey - Analyst*

And then the other question is the Sarbanes-Oxley - the last time I asked this question I think was three months ago - you said that you still plan on signing a Sarbanes-Oxley letter by late '08. Has that timeframe changed at all?

Buddy Piszel - *Freddie Mac - CFO*

No, that's not. And it would be in conjunction with our year-end financial statements. You sign that once a year in conjunction with your annual audit and it would be - literally will not have to be Sarbanes compliant by the end of '08, but we would intend to be.

Paul Miller - *Friedman Billings Ramsey - Analyst*

Why wouldn't you have to, just out of curiosity?

Buddy Piszel - *Freddie Mac - CFO*

Because as a new SEC registrant, we've got a one-year waiver, so we literally don't have to be compliant until the end of '09, but we think it's in the best interest and our shareholders to be compliant earlier.

Paul Miller - *Friedman Billings Ramsey - Analyst*

So if you file current financials next summer, if that timeline is still correct, you have one year before you got to sign the SOX letter?

Buddy Piszel - *Freddie Mac - CFO*

Right, but our intention would be to sign it with our year-end financials for '08.

Paul Miller - *Friedman Billings Ramsey - Analyst*

Okay, thank you very much.

Ed Golding - *Freddie Mac - Investor Relations*

Operator, can we take one more question, please?

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Operator

Certainly. And that question comes from the line of Thomas Mitchell with Miller Tabak. Please go ahead.

Thomas Mitchell - *Miller Tabak - Analyst*

Is there - in looking at your mix of business, is there a way for us to estimate going forward the changes that are taking place in your risk profile, that is as you meet your obligation to, under your charter, undoubtedly you're going to increase the risk profile of the assets that you guarantee and hold. Where will we see that appear?

Patti Cook - *Freddie Mac - EVP, CBO*

I think our additional disclosure over the last couple of months, both around subprime holdings and the retained portfolio, and then with this release, the additional disclosure we've given to you around our Alt A purchases will continue to highlight those differences. I mean that is the right place to look. So look at our subprime purchases. Look at the disclosure we gave you today in terms of Alt-A, which supplement the other information that we give you on the portfolio overall.

Buddy Piszel - *Freddie Mac - CFO*

Yes, Tom, this is not a one-shot deal on this disclosure. We're going to be providing the expanded disclosure going forward.

Thomas Mitchell - *Miller Tabak - Analyst*

Okay. Great. Thank you.

Dick Syron - *Freddie Mac - Chairman, CEO*

Well, I want to thank all of you for your time. And if there are any follow-up questions, obviously Dan - would be anxious to take them. It's a testing time for all of us, but we think it is also a time of great opportunity for us. And to reiterate what I said before, it's in this kind of market that you really do see what the value of the GSEs is. Thank you.

Operator

Thank you. And ladies and gentlemen, this conference will be available for replay starting today, Thursday, August 30th, at 1:30 PM eastern time, and it will be available through Thursday, September 13th at midnight eastern time. And you may access the AT&T executive playback service by dialing 1-800-475-6701, and then entering the access code of 883319. That number once again, 1-800-475-6701, and if you are dialing from outside the United States or Canada, please dial 320-365-3844, and, again, the access code for today's call is 883319. And that does conclude our conference for today. Thanks for your participation, and for using AT&T's executive teleconference. You may now disconnect.

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