

FINAL TRANSCRIPT

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FRE - Freddie Mac at Goldman Sachs Financial Services Conference

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Freddie Mac - EVP and CFO

CONFERENCE CALL PARTICIPANTS

James Fotheringham

Goldman Sachs - Analyst

PRESENTATION

James Fotheringham - *Goldman Sachs - Analyst*

Good morning. My name is James Fotheringham. I cover mortgage and specialty finance at Goldman.

It gives me great pleasure this morning to introduce Dick Syron, Chairman and CEO of Freddie Mac. Dick, as many of you will know, is an industry veteran, who spent time, as well, as a bank regulator.

As many of you will know as well, the last couple of quarters have been tough ones for Freddie Mac. And, while we've seen significant losses on a GAAP basis, there's plenty to be optimistic about. We've seen the development of G-fees, (inaudible) expansion, the anticipated normalization of administrative costs.

And, to talk about these trends, both positive and negative, I want to pass the podium over. And, Dick, thank you very much for coming. We very much appreciate it.

Dick Syron - *Freddie Mac - Chairman and CEO*

I'm Dick Syron, as Jim said. Thank you all for coming. I want to thank Goldman and James Fotheringham for giving me the opportunity to talk to you this morning about what's been going on at Freddie Mac and, more importantly, what we think is going to go on going forward.

Actually, since we released third quarter results in our preferred offering a couple of weeks ago, we've spent a lot of time talking to investors. So, for some of you, this may be redundant because, fortunately, even in the Freddie Mac world, things don't change every day overnight. In light of that, I think the best thing I can do this morning is keep my remarks relatively brief. And it always benefits us more when we're able to answer your questions rather than try to anticipate them and tell you what we want to tell you. My primary focus will be on our market role and the steps we're taking to through the current environment. Afterwards, I'm going to ask our Chief Financial Officer, Buddy Pizel, to give you a brief update on credit and financial reporting.

Let me start by summarizing our main takeaways, and then I'll get into a little more detail on each one. Freddie Mac, and I think this is very important in terms of viewing its long-term value, has played an important stabilizing role in the housing and finance markets through the significant turmoil of 2007. Many people, as you know, have said the one part of the market that's working is the conventional/conforming market. And that is something that we've been doing for some substantial period of time.

We've significantly benefitted from more rational pricing in our guarantee business-- That's just beginning to be shown-- and from margins in our portfolio business. And that will contribute quite significantly to our returns in the future.

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Now, while our credit expenses have remained-- have increased significantly in the past six months, our portfolio, and we have some data to show you this, remains one of the strongest in the mortgage/finance industry. And, to some extent, that's an artifact of the part of the mortgage/finance industry that we play in. And we'll bring this back into sharper focus as we talk about the evolution of the market going out from here.

Our management team has taken significant steps through 2007 to enhance our ability to weather this downturn, which is really very, very significant. And I agree with people that say this is the most important correction we've had in housing since World War II. As our successful preferred offering last week shows, our senior management is committed to take the changes that serve our charter mission and doing so, though, in a way that fulfills our fiduciary responsibility to our shareholders. And let me come back to how we constructed that offering and how that reflects this.

Now, it may seem obvious that we're a rather unique financial institution. You're going to hear from the one other institution that makes us not unique a little later today. Unlike banks and brokerages, Freddie is chartered to focus solely on the \$9.4 trillion conventional/conforming residential mortgage market. And our mission, as stated in our charter, which is our core asset, is to provide liquidity, stability, and affordability across the cycles, good times and bad, to our customers.

We carry out this mission in two ways. First, on the left, and I think a lot of you know this, we're an insurance company. We guarantee credit risk on residential mortgages in the single-family business. As of October 31, we guaranteed a total of about \$1.7 trillion in residential mortgages in the United States, an amount that represents about 43% of the total GSE share. In other words, we have 43%, and Fannie has about 57%.

Now, an important factor is that, over time-- our regional diversification, and we can talk to you about that, and our focus on conventional/conforming, prime loans has helped Freddie to promote affordable home ownership but has also helped us to record credit losses that are far lower than the industry as a whole. So you could look at the business, I guess, on your left as kind of a credit risk management business. If you look on the right, we have a portfolio of our own. It's got a balance of around \$700 billion. And we invest it in securities, where we manage interest rate risk. So the left side is kind of credit risk; the right side is interest rate risk.

The case historically has been that (inaudible) very, very low levels of interest rate and credit risk in our retained portfolio. Specifically, 99% of the securities in the portfolio business, the one on your right, have security ratings of AAA or better in a duration gap over time. We focus a lot on duration that's average zero months. We're a matchbook provider. We don't bet on the direction of interest rates. We make money over the long term, through the core spread (inaudible) the portfolio.

What's the takeaway? The takeaway from this slide is that, over time, Freddie has succeeded in generating good returns from both our guarantee and investment businesses while keeping our risk exposures very low. We're a high-leverage, low-risk operation. This strategy has enabled us to profit with others when times are good and to help keep serving our mission, strengthen consumer ties, and build market share when times are tough, like they are now.

At the risk of being obvious, let me interject something here in the interest of full disclosure. As you can see from the slides of what our businesses are, we're totally tied to housing finance. There's no way of getting away from it. Right now, that's a troubled sector. It's the reality of life. And, when credit deteriorates and spread widens, companies in this sector take meaningful GAAP losses, as we did in the third quarter. Those losses were exaggerated and augmented by our-- I'll use the word, and Buddy can correct it later-- crazy accounting treatment, but the losses were still there. We can talk to you how much we think is real and how much is accounting, but the losses were still there. But, given these facts, market conditions have not reversed course significantly, and we want to be honest with people. We've tried in the last several years to be very straightforward and transparent - very important in a complex organization like this. Our fourth quarter results are not going to be expected to be better than they were in the third quarter. Now, having said that, management feels very strongly about the future of the franchise, reinforced by our capital raise - our \$6 billion capital raise.

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And now I want to turn into sort of from what we've been talking about and what we reported to what we think the issue is going forward. I do want to be sure, and I think you'll hear this from a lot of people in this conference, that we're not promising that there's a silver bullet, that there's a short-term, quick fix, because, again, we want to be candid and that's not what we're saying to you today.

Let me go back now to the point I made earlier about our mission and how the GSEs are built and, actually, were established for times like these. Over time, Freddie Mac's continued involvement in the U.S. mortgage market has allowed us to provide support at critical times. That's what provides the broader public support that reinforces our charter. We provided stability in the mortgage market through a number of crises - the Russian financial crisis; LCTM; the events of 9/11; on a regional basis, in hurricane Katrina; and, now, during the current housing crisis. I mean, how many originators have you heard say - The only business we're doing is business we can sell to the GSEs. So this is the time that the market's coming to us. We're providing liquidity and stability in a market that I think even our critics have said would be in much, much worse shape if we weren't there.

So how does that relate to you? Actually, even in the past six months, the conventional/conforming, prime market has performed relatively well, with homeowners continuing to source funds for home purchases at historically very, very attractive levels. This is a complete aside, but when I got my first mortgage-- And I'm not going to tell you how many years ago it was-- I never thought I'd see a mortgage that had a single digit to the left of the point. But things have changed dramatically.

In addition to assisting the market, though, we've benefitted from the current environment in ways. Let me just walk through some of that.

In our guarantee business, the \$1.7 trillion business, there's been a shift in originations back towards kind of our sweet spot, or our wheelhouse - back towards long-term, fixed-rate products. That has helped us to increase our total market share penetration of the total U.S. mortgage market to about 28% through the end of September. This is a dramatic change from relatively recent periods, when there were very, very high ARM productions, and a lot of the high ARM productions went to the Street to be securitized.

In addition to assisting the market, we've benefitted through the current environment in several other ways, and let me get to that.

The volumes that I talked about with our increase to 28% in the overall market are coming in a much improved pricing environment and tighter credit standards than a few years ago. As credit has tightened and private-label securitization has declined and almost dried up, we've experienced better pricing in our guarantee business while actually being able to tighten credit standards at the same time. During the third quarter of '07, we averaged mid 20s in our guarantee fee business, up very dramatically - significantly - from the year before. And, more recently, we announced a price increase in our business of about 25% that will take effect in 2008. This is obviously part of what's happening in credit markets worldwide that we're finally seeing a return to rationality across the entire credit spectrum.

Now, we don't think the current cycle is anywhere near over, but it's important to note that our recent purchases have already started to turn around in both volume and price. And our retained--

This is the great irony of this. I'm going off script here for a second. Because of accounting and other issues, and Buddy will get into this, we've reported really ugly numbers. Let's face it; really ugly numbers. But we reported really ugly numbers at a time where the business that we're taking in, as you look at what's coming through the door, has got terrific returns on it. So it's a matter-- And we, to some extent, decided to take our pain up front, and we can get into that later on. But we took a very, very, very aggressive approach towards looking at potential future credit losses, which makes the current situation look pretty lousy, if I can use that word, at the same time that our business going forward looks better and better. It's an odd situation.

In our retained portfolio, we're currently benefitting from improved core spreads, as OASs have widened quite significantly. The OASs, from an accounting perspective, their value [hurt us as they widened], even though they mean, with each additional

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product we take in the door, we're making more money. Our underlying assets in that portfolio are very high quality, and we continue to enjoy extremely attractive funding levels relative to LIBOR. We have a spread relative to LIBOR now of about 60 to 70 basis points under, compared to 25 or 30 basis points last year. And that shows real opportunity for investment.

I can't stress this too much. Whereas the returns available to us in the retained portfolio were relatively unattractive throughout the 2004 to 2006 time, and a lot of business returns were unattractive, the ROEs on new business we achieved in the last year have been much, much better. Now, while we're not aggressively growing the retained portfolio in the interest of being sure we keep our capital powder dry, we're not shrinking it either. And we've been able, as our assets roll over-- about \$10 billion a month rolls over through the retained portfolio-- to replace that with more attractive business coming on.

Finally, we feel that our credit position in the current guarantee book, actually, is very near the best of the entire industry. A very major reason for this is that we have very low exposures to alt A in risk-layered mortgage products in the guarantee business. We didn't do any subprime business. And, if you look at layered products and alt A, they together amount to about 9% of our total guarantee portfolio. As a result, thus far, we have a delinquency rate-- a serious delinquency rate of about 51 basis points. The rate for the industry as a whole is about 100 basis points, or about 1%. So, if you look at that, and I think it is a valuable lead indicator, it shows the relative - relative - security of our portfolio. Now, this combination of improved pricing and margins on new business with continued low risk in our existing portfolio is what we think bodes well for our future.

Now, despite these improvements, we faced a crucial turning point earlier this year. As you all know, we're required to hold a certain amount of capital. It's statutorily imposed. Then we're required to hold a 30% surplus over that capital. Then we're required to hold a surplus over the surplus to make sure you don't go through the 30%. And we were looking at, given accounting and other artifacts, a situation where we were dancing on the edge. And we thought there's, basically, two choices we could face. We could drop back into-- this is probably the wrong words, but I'll use it (inaudible)-- kind of a Fortress Freddie. Shrink the retained portfolio, try to really crank back-- which wouldn't be serving our mission, thereby hurting our charter longer run-- crank back on what we're taking in on the guarantee portfolio, and see how we could squeeze through this, and hope that, when things come out the other end of the tunnel, we'd be in a position to get the business back. That's a fairly dicey proposition because, once you lose a lot of share, whether you'll get it back or not-- It's different trying to reach for share than it is giving up a lot of share saying we'll get it back later.

We had to make a difficult decision. We're very, very, unfortunately, aware of what's happened to the stock. We wanted to dilute the common shareholders like we wanted to shoot ourselves in the head with a gun. So we said - What do we do? Well, we said the really responsible thing for the shareholders in the long run is to look at - What are we going to need to get kind of with any reasonable scenario? A reasonable scenario for us is defined as a decline in housing prices of about 10% peak to trough, close to 30% in California, Nevada, and a few other places. But how could we--? Do we want to raise enough to just sort of get into next year and then see what we're going to do in the middle of next year? Or do we want to say - What can we do that, in a reasonable scenario - not the total bottom falling out - but in a reasonable scenario, gets us across the trough? And we decided we needed about \$6 billion to do that. We wanted to do this, and we didn't know that we could, initially, with as great a share of that being as straight preferred, with no convert in it, as possible. Quite honestly, our bankers didn't think we could do that, originally.

We went out on a road show. We found there was very, very strong demand for our paper, and we did, as you know, a \$6 billion straight preferred issue with no commons, in order to minimize the dilution of our shareholders. And we think that we did the right thing.

And we think it affirmed our position in three ways. One, it committed our ability to maintain our strategic position through the downturn. We can stay in the market. We're able to deal with this increased market share in the guarantee business at more attractive pricing - at rationale pricing - than we had before. We dealt with some regulatory concern by raising the money. Second, our high asset base coupled with tangible improvements in our business and better underwriting standards and stronger margins make us much more confident about our ability to earn on this money. And, third, as I mentioned, we did it without diluting our common shareholders unnecessarily by doing it all in the straight preferred.

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As I said, and I think the chart reflects this, our current expectation is for housing prices in the United States to fall about 10% peak to trough. Now, don't forget; what's important for us is the decline that occurs in the prime conventional space - not in the jumbo space and not in the subprime space and not largely in the investor space - but in the prime conventional space. And we think this is a relatively-- It's worse than anything we've seen. We think it's a relatively conservative and pessimistic strategy. And we think that, as we look at our portfolio, given areas that we can't invest in, like California, we'll get a better draw, if you will, on credit risk than the market as a whole.

In this forecast, the important numbers are really that we expect a default rate of about 3% to 3.5% and a severity rate of 30%. The product of those two numbers is what you lose. To put it in context of the worst that any of us have seen has been a decline-- it's about 2.4% in defaults and a 30% severity. So we think we've taken prudent steps to provide for what's going to come. Now, there are other things we could do, and we're prepared to deal with them, short of the world totally melting.

If our expectations are realized, we would expect that our total future credit losses from our current book of business will total approximately \$10 to \$12 billion. The reason I wanted to raise that number is, a lot of you, I think, realize that, in the interest of credibility, we decided some time ago that we were not going to mark to market expected credit losses in our portfolio - that, rather, we would go out to the Street, to you all collectively, in a sense, and we'd ask you - How would you price our book? Now, we're asking you from an obligation perspective. We're asking you to price something that you don't deal in. We're asking the Street to do that. So, particularly during this period of time, you're naturally going to do that fairly cautiously. The number they came up with for the obligation in our book is about \$16 to \$17 billion. That's the number we used, even though we think, based on the numbers that we gave you about the 10% decline in the severity and default ratios, that what we'll really realize is close to \$10 billion. So we built in kind of a cushion here. And it would take a credit environment-- To realize the \$17 billion that we built in, it would take a credit environment that was more than twice as bad as the worst experience we've seen since World War II. So we think that we've been quite cautious in this, but we've done it in the interest of trying to assure people where we are and where we're going.

What I'd like to do now is turn to Buddy for just a few minutes, have him go over some of the data, then we're going to finish up and turn, much more importantly, to your questions. Thanks a lot.

Buddy Pizzel - Freddie Mac - EVP and CFO

Good morning, everybody. I'm going to hit on two points and then try very quickly to get to your questions.

The first point is - We still have a lot of confidence in our subprime and alt A-backed ABS. And the second point is - We continue to make good progress in our controls; [I am] the crazy accounting solutions, and we're working on that too. And, also, in a new adjusted-GAAP presentation, I think that will make things a whole lot clearer.

This next slide makes the point about the high credit quality of the overall retained portfolio. 99% of the portfolio is AAA or agency securities. We have no CDO exposure. At September 30, we had \$105 billion-- that is the orange-- in AAA-backed ABS. We started the year at \$125 billion, so that is paying off rather quickly. We also have \$53 billion in alt A-backed ABS. Nearly all of the subprime and the alt A-backed is AAA, and both have significant subordination levels.

Now, let me dive a little bit deeper into the subordination. This slide gives you a better sense as to where our subordination levels are by vintage year. And you can see, for the '05 and prior books, our credit enhancement is basically greater than 50%. For the '06 and the '07 vintages, it's closer to 30%. And at the alt A, it's closer to 20%. A couple of points to make here. Less than 2% of this portfolio has been downgraded as of mid November. A lot of people have been analogizing to the ABS index in evaluating this portfolio, and this portfolio is different than the ABS. The ABS counts a back portion of the AAA cash flows to about 15% of the cash flows. In all of our subprime holdings, we have all three pieces of the cash flows - the front, the middle, and the back. Accordingly, we receive our cash flow a lot faster, and these things pay down quicker. And, every single month,

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our subordination level grows. And, if you think about this slide-- Actually, this slide shows you that the '05 and prior vintages are growing in subordination.

As of September 30, we had \$3.5 billion overall unrealized loss in this portfolio, and I want to emphasize the point that it's unrealized. And it's going to continue to be unrealized. We stress test these portfolios every single week. We look at what the expected cash flows are going to be. And, even with a 50% severity and 50% default rate, we get no cash losses. And, with every passing month, you can actually toggle that up. So, again, as long as there's going to be no cash losses-- We get the question - Well, are you going to have to take bookkeeping losses? You don't have to take bookkeeping losses unless you're going to expect cash losses. We hold this portfolio, so we're not anticipating any impairments. So, despite all the noise, we feel really good about the ABS and the alt A-backed portfolios.

Now, let me turn to financial reporting and our crazy accounting. We are hoping to hear this week from the SEC. We've already been engaging the SEC on a number of changes that would change the way that we recognize credits on the G-fee business. That was the left-hand side of the slide that Dick showed earlier. And, in a lot of ways, it would mute the mark-to-market noise that we currently reflect in our G-fee business. We would look a lot closer to Fannie and the way they put their G-fee business out there and recognize credit. We are on track on our control remediation issues, and by yearend we should have resolved our material weaknesses. We will be timely at yearend. We will get our financial statements out in 60 days. And, as I said earlier, we are very close to completing an adjusted-GAAP presentation. But I think, once we roll it out to folks, it will make a whole lot more sense as to how to look at the business. Basically, we're in an accrual-based business. We should see our earnings and margin on an accrual basis. And this allows us to show you how we think is an effective way to look at the profit [emergence] of the business. We'd like very much-- And, also, we're going to do it on a segment basis, and we've not done that before. So we'll show you single-family, multi-family - the retained portfolio performance on a segment basis. We think it's a much clearer presentation. We would hope very much to get that out by yearend. Our priority, quite frankly, is to make sure we meet our 60 days. So, if it's not done by yearend, we'll get it out shortly thereafter. But, surely, it will be out there as we go to continue the SEC registration process, which we are still on track to complete sometime midyear.

So, just to summarize, I think we feel good about the ABS and the alt A portfolios, and all the work we're doing around our crazy accounting is making progress.

With that, why don't I stop, and we'll open for questions.

QUESTIONS AND ANSWERS

James Fotheringham - *Goldman Sachs - Analyst*

Thank you very much. I'll open with the first question as people think about what they want to ask.

Dick, just given the important role that the GSEs need to play in the current housing predicament, what are your prospects for regulatory relief? What are the chances that OFHEO can lift the portfolio cap or the excess capital requirements sometime during 2008, after you've presumably returned to timely reporting?

Dick Syron - *Freddie Mac - Chairman and CEO*

Well, as I understand it, in the agreement we have now-- Now, of course, you need an army of lawyers to decipher all this stuff. Our agreement is that the 30% comes off when we return to quarterly reporting, and we've already returned to quarterly reporting. The regulator has, I think, has quite strong views on this. I think (inaudible) to talk about it at CNBC yesterday. My own view-- As you were kind enough to note, or maybe not kind enough to note, I was a regulator for 20 years and, particularly during the very bad time of the banking crisis in New England. Sometimes you have to weigh off how you treat individual

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institutions and what you think the impact will be on the economy as a whole. To be honest with you, I'd come down in a different place than he does, but that's his freedom to do that. The reason I say this, and it is going back to what I did before, I think this is a tough time. And, to be honest with you, I think it's going to get tougher before it gets better. But we're not betting. And this has to do with the-- and it is betting, in a sense-- with a desire to go out and raise capital, which we did successfully, on an early release from the 30%. My opinion on it is my opinion. It's the opinion of a lot of other people. The regulator's opinion is what wins in the short run. I think, actually, on the limits-- The 417 limit, I think, is going to be-- I've been surprised it hasn't been more, but I think there will be a lot of political pressure on that. I mean, the idea of trying to pretend that a \$417,000 limit is as applicable in Manhattan and Manhattan Beach as it is in Manhattan, Kansas is just pure [false]. And I think that's going to be recognized.

Unidentified Audience Member

It may have been a throwaway, but you offered the comment you think it will get tougher before it gets better. I'm wondering what it is you're specifically referring to and what causes you to believe that.

Dick Syron - Freddie Mac - Chairman and CEO

I'll tell you what causes me to believe it. One is, I think, if I were you-- This is my advice. If I were you, I would want in this time period someone running one of these companies and the team running the companies to err on the side of pessimism rather than optimism because of where we've been. I think, if we're three years down the road in this and someone says, Gee, you could have made a little better if you were much more aggressive and went [to shear], I think that criticism I'm less worried about than someone saying, You guys called the turn way before it happened.

The other thing that concerns me about it getting worse before it gets better is kind of the potential impact this has on the economy overall. What I mean by that is we've seen a ton of foreclosure notices mailed out to people so far. But we haven't seen a lot of pictures in the "Times," in the "Journal," or in a lot of local papers of people standing in front of their house with their furniture on the front lawn saying, What am I going to do with it? We haven't seen a lot of forced evictions yet. As that starts to happen, and it will happen, I'm afraid of the impact that this has. I mean, household wealth in housing is about \$21 trillion. That's against a GDP of, what, about \$13 trillion. It doesn't take a big shift, we all know, in consumer confidence and consumers worrying about things for it to have an effect on the economy. And the reason that I think it could get worse before it gets better is, so far, this is mostly a correction toward, admittedly, what was a bubble in housing prices; and it hasn't been augmented by an employment effect or a macroeconomic effect. And I think that could happen.

Unidentified Audience Member

I have two different questions. The first is to look back at the Company's actions in '05, '06, and the first half of '07, when it was pretty clear that credit risk was being priced poorly from the standpoint of those who were purchasing it, and your portfolio was growing at mid to high teens' rates. You clearly made a strategic error. Can you talk about looking back on that time and how you might learn and do better in the future?

Dick Syron - Freddie Mac - Chairman and CEO

Yes. I think that's a tough question; it's the right question. I think it is the right question. Now, it's a tough time. We didn't do everything perfectly. To some extent, some of this we had control over, and some we didn't have control over. As you know, and I think everyone's got to take a look at this model, the way that the industry works - the GSE industry - is that we give people a price sheet - a price grid, if you want - kind of for a year in advance. And then we have a [pay or take] or whatever you want to call it. They deliver us the product. We've contracted that we'll already take-- that we'll take that. So we can't in our flow business turn the spigot on and off every day and say, Gee - I don't want that product. You could say, even a year before that,

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when those contracts were being established - Should we have tightened up on some things? I think the answer is yes, to some extent. It's tough, though, because, to be blunt about it, in a duopoly-- In '03, our market share dropped to 33%. It's pretty tough when the other guy's twice your size. We came back to 43%. Don't get me wrong. We don't have to draw any lines in the sand. We're going to defend the market share at a certain price. But you don't want to drop to 20% or 25% either. And market pricing was crazy for us the whole sector. So some of this stuff, you would have had to turn the spigot a lot ahead of time.

Where this is, I think, even more, though, ability for criticism is some of the stuff we took in the bulk business, where, on balance, we probably did what you'd about expect people to do. But, looking back, I wish we'd been more pressing and had tightened up on it, to be honest about it. And I think probably there were, at the margin, some mistakes, and we're committed to not do it again.

Last comment. I will say, I don't think-- We were early bears on the market. But an early bear on the market, from our perspective, was saying we expected to go to zero-- nominal price appreciation-- (inaudible)-- which would have meant a decline in real-term housing prices. We, as you know, actually saw a hairpin turn in what happened in housing price appreciation. And I think, candidly, it got much worse than anyone expected. But, should we have done better? Yes.

Unidentified Audience Member

As a follow-up on a completely different area, can you talk about administrative expenses? You obviously should be peeling away the extra costs for the remediation of your systems. But, beyond that, presumably, given the state of the Company's financials over the next two years, you should be able to go further and really tighten the belt.

Dick Syron - Freddie Mac - Chairman and CEO

We intend to do that. Actually, our administrative expenses have declined slightly, and we've reduced-- When I came to the Company, we had 3,100 consultants, or maybe it was 3,000. Now, it's down to 1,700. It will come down a lot more as we get to the other side of the early part of next year and the compliance issue. I do want to turn this specifically over to Buddy, but let me tell you one thing we are committed to do. We have been working a long time. We haven't got done fast enough what needed to be done in remediation. We can-- It's not that we can see the light at the end of the tunnel; we can smell the air. And we're not about to do anything right now in these next few months to jeopardize that.

Buddy Pizsel - Freddie Mac - EVP and CFO

If you think about where we were before all the trouble hit, we were running about 6 to 7 basis points in the mortgage portfolio. That ramped up to 9 basis points. It will end the year somewhere - 8.5 to 9 basis points. We think it should get back to 6 to 7 basis points by 2009, with a big deposit in 2008, because, as we finish all this remediation, we're going to have all the consulting and all the professional services walk out the door and start-- That will be the first deposit. And then we'll just get efficiencies for the second piece of this through attrition and through managing our workforce better. And I say that's a starting point. We'll see on a going-forward basis the continued leverage we can get on this business model, because we don't have to add people for every dollar of additional G-fee business in retained portfolios. There's a lot of leverage in the model. But I think, at this point, we can commit that we'll be in the 6 to 7 basis points range by 2009.

Dick Syron - Freddie Mac - Chairman and CEO

And just-- You can tell that we feel fairly intensely about this and sensitive about it, which is because, I think, you raised the right question. But, when I lived down here, people said, Money talks and something else walks. But, just so you know that we're doing things on this already, even though we're not at full remediation, we put a hiring freeze in effect, and we're already down-- it's not huge, but-- a material number of employees from the time that we put it into effect. We're committed to doing this.

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James Fotheringham - Goldman Sachs - Analyst

Thanks. Dick, can you talk a little bit about the price increase? I found that pretty interesting. You made the comment, and we all know, that all the originators are having to go towards conforming product now. That's a terrible business for them from an origination fee, etcetera, spread business, so their profitability is already under a lot of pressure. Now they have to pay off, etcetera. Can you talk a little bit about some backlash maybe from the originators, if you can? And, also, on the regulatory side of things, we're all worried about keeping people in their homes now; arguably, the price of a mortgage just went up again. Just some comments on that would be great.

Dick Syron - Freddie Mac - Chairman and CEO

Yes. Look, at the end of the day, at least in the short run, economics is a zero sum game. I think we would all agree-- maybe not. But I think most people would agree-- Paul Volcker said this in the "Times" Sunday-- what day is today? Maybe it was the "Journal" yesterday. I forget-- that we're returning to rational prices. The credit for everything, just about, was priced too loosely around the globe. So you have to get back to rational pricing. Our originators were not thrilled by the price increase. We didn't hear an enormous amount of screaming back. And I think that's because they realize-- Look, last week, we hurt our common shareholders by cutting the dividend-- two weeks ago-- by cutting the dividend in half. We went out and we raised with that \$6 billion in preferred because we had capital concerns. The way you get capital-- The way you want to get capital over the long run is by generating earnings, and we just plain weren't generating enough earnings on the basis of the prices that we were charging, particularly in the current risk environment. And we have three responsibilities - liquidity, stability, affordability. But we're a publicly chartered company that has shareholders. So I don't have the right, nor would I want the right, nor do I intend to be in a situation where we say we won't do what's right for the shareholders in order to subsidize some other market. We're just not going to do it. And we did what any other business would have done in this environment. And I think, quite honestly, I believe that the GSEs are necessary for the health of the U.S. mortgage market in the long term, and I think that requires healthy GSEs. And I think healthy GSEs required a price increase.

Unidentified Audience Member

(Inaudible question - microphone inaccessible)-- that the results had covered, basically, half of that credit loss. So, if those expectations play out, wouldn't you essentially erode the new capital that you just raised?

Buddy Pizel - Freddie Mac - EVP and CFO

Well, you think about the timing in which this is going to emerge. And I said that we're trying to take some actions, because the big way that the credit emerged in the third quarter was on these marks. And some of the marks and some of the accounting we're trying to get out of because we don't think it's representative of where, ultimately, the credit will come from and the way it should be emerging in the numbers. So, you're right. We said that we're expecting defaults in the \$10 to \$12 billion range overall. We've taken \$4.5 billion through the first three quarters. So we're basically halfway there. We're assuming we're going to take the rest over the next couple years. But, remember, we're getting earnings. So there's retained portfolio earnings, there's the fees that we're earning on top of that. We've announced the fee increases. There's going to be reduction in the G&A. So there's a lot of other sources of profits that contribute to what the overall P&L outcome is going to be.

Unidentified Audience Member

Could you describe what the G-fees are as a percentage of income today and where you think that will be three years from now?

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Buddy Pizsel - *Freddie Mac - EVP and CFO*

As a percentage of income, clearly the way we see the two businesses-- The G-fee business is going to be growing on a consistent basis for years to come. And you pick the rate of MDO growth that you're assuming, but historically it's been 8% to 10%. In a period like this, it's growing more like 16% year-to-date basis. That will probably slow down a little bit as things stabilize. But we're assuming, at least going forward, we're a good 8% to 10% growing on the G-fee business prospectively. The retained portfolio, quite frankly, we think should be more opportunistic. When spreads are wide the way they are today, we should be buying and deploying capital. When spreads tighten up, we should be pulling that back and then deciding what to do with that capital. But it's not going to be the same kind of steady growth business in the future.

Unidentified Audience Member

What's the split between the two today, and what's the split between the two in terms of contribution of earnings today and where you think it will be three years from now?

Buddy Pizsel - *Freddie Mac - EVP and CFO*

You will find out in a couple months, because the adjusted-GAAP presentation really is the vehicle to be able to lay that out to you in the segment reporting. Right now, we're giving a one-- Everything's lumped into one P&L. We need to break it out separately. We need to lay the expenses up against each of the businesses and the capital against each of the businesses. And I don't want to front-run that work if it's not done yet. But you'll be able to see that clearly (inaudible).

Unidentified Audience Member

Why don't you run off all the on-balance-sheet business? That seems to be the principle concern of your regulator. It's not really the credit loss; it's the ability to fund it. I've been astonished for a couple of years how you could not have run it off when credit spreads were zero to negative. What was going on there? How could you have--? How could you have put on tons of new business in the history-- in the narrowest spreads in the history of the business? And what would you prevent you from running it off and freeing up all that capital that you've got to hold against it?

Dick Syron - *Freddie Mac - Chairman and CEO*

The first answer is, particularly right now, there's a difference between what you let run off in the terms of letting the portfolio, as you say, run off at about-- It's about \$10 to \$12 billion a month that it runs off. You don't want to go out and sell the portfolio in this market, where it's marked down.

The other factor is that, in some periods, the retained portfolio has been a very, very important source of earnings. I think, as Buddy said, we want to look at it opportunistically. Also, from a mission perspective, to provide liquidity and stability, we need to use the retained portfolio at times. And, also, you know that we have a security price performance issue, which is something we have to take into consideration in what we do with the retained portfolio.

Having said all of that, it's clear to me that we do have a sea change in what's happening in mortgage markets. Maybe we had a sea change the other way six, seven, or eight years ago; I don't know. But the GP business, the guarantee business, is going to be a relatively quite attractive business going forward, and I think you can anticipate our emphasizing the GP business significantly more than the retained portfolio as we go forward.

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Buddy Pizel - Freddie Mac - EVP and CFO

Let me make a couple points on run off because I think it's a mistake to think that you could just run off, make no purchases in the retained portfolio, and redeploy all of that capital. A couple of points. One is, the multi-family business uses the balance sheet. So, in every given month, there's a certain amount of purchasing we're doing just to continue that business. That's good business. It's good ROE business. We're going to continue to do it. At least prior to our announcement the other day, we had to use the balance sheet for the purchase of loans that were going over 120 days delinquent. That will stop going forward, but that was a significant on boarding onto the balance sheet. And the third is Dick's point - security performance. Our securities trade worse than Fannie. We have to do a certain amount of purchasing in our own agency securities in order to sort of keep that gap narrow enough so that our G-fee business is profitable. You take all of those things combined and you use up-- If you think about 100%, probably 50% to 60% of your purchasing has to be done to support those three causes, which means there's something on the margin there that you're looking at to see if you're getting effective returns. Over the last couple years, while the returns weren't great, they were higher than our cost of capital. And the purchase in returns weren't very good, but we have a very good unit that does a lot of structuring. We were able to achieve reasonable returns on our capital during that period of time. And, oh, by the way, during that period of time, we were stuck with this capital. The regulator wasn't going to allow us to give it back. So, if you're stuck with dead capital, do you want it to just sit there dead, or do you want to put it to some kind of use? And we chose to put it to some kind of use at reasonable, although not great, returns.

Unidentified Audience Member

Dick, I wanted to ask a question about your economic outlook. As things get worse before they get better, the political timing is quite interesting ahead of a White House election. So, as the legislators feel compelled to do something about this mess ahead of the election, we anticipate seeing lots of legislative initiatives. I'd be interested to know from you what legislative initiatives you see having the greatest chance of making themselves into law.

Dick Syron - Freddie Mac - Chairman and CEO

I'm afraid I may not have a pretty answer to that. Legislation and finance makes a nasty mix for a whole lot of reasons. What I am concerned about in this is, in the understandable and perhaps laudable goal of helping a lot of people that, in some cases, were [victims], that steps will be taken that help them that hurt capital markets in the longer run. For example, I think, to be blunt about it, if you're a securitized lender, you have to be able to get at the security behind-- asset-backed lending. You have to be able to get at what's ultimately required.

I want to make one other comment on this, though, because we do have the proposal that the White House made, which, I think, on the margin is constructive. We could debate it, but I think, on the margin-- Take its good points and its bad points; I think it's constructive. But, if you take the subprime market, where there's going to be a lot of heat-- there is a lot of heat-- there's a good third of that that's people who never should have been [in houses] in the first place. Now, let's be honest with ourselves. We went crazy as a country with goals. We went crazy with a lot of other things. We at Fannie and Freddie contributed to this, with saying everybody's got to have a house. Everybody [can] have a house. And the way this has to be resolved in the end is you do have a match between kind of units and people that need to live in them. But they may not be able to live in them as homeowners. So we're going to have to find a way as a national effort to convert a lot of the stock of housing-- not a lot, but a material amount of the stock of housing that is now held in shaky hands as owner-occupied and convert it to rental housing with someone else holding it with all kinds of mechanisms - maybe warrants and things for people. And I think that's going to be a huge political challenge. And I think that challenge is going to hit late spring or early summer next year, which, as you say, is going to be a very interesting time.

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Unidentified Audience Member

I just wanted you to comment on some of the home price appreciation expectations. You mentioned that maybe a year ago you were predicting a flat HPA, and some others might have been maybe more aggressive - the National Association of Realtors, for example. Now you're looking at a 10% decrease, yet you also mentioned that there was-- maybe one-third of the subprime owners should never have owned homes. I would imagine anyone who's an insider understood about the mortgage brokers and the conflicts there and the lending practices and the [wire] loans and the phony appraisals and all those things that are now fairly well known. But the insiders knew about them. So how can you be so confident that there isn't a permanent change or a semi-permanent change in demand for these types of products, the option ARMs, etcetera. You're raising fees, maybe justifiably. But it's going to be much harder to get a loan. So 10%, and, obviously, a think a higher number for Florida and California, actually, again, seems to be a little bit too optimistic in my view. So can you comment on that? And, given the track record of people in terms of that--?

Dick Syron - Freddie Mac - Chairman and CEO

Sure. If you go back to a year ago, I think we were expecting-- We've been expecting some negative. I wasn't expecting as much negative as we're seeing. But let's put this in context. This is a very different decline in housing prices than we've seen before. This is going to be about a two-and-a-half-minute answer. I'll try to keep it to one and a half. All the previous declines that we've seen, including during the '20s, were driven by economics. This is the first one I can find, and there's a lot of international factors-- I won't go into that-- that's been driven, in material, by a bubble. Having said that, a 10% decline in housing prices, and I'm talking in the prime conforming space-- I'm not talking of translating that into taking into consideration what happens when the above \$417,000-- what happens in the subprime stuff. In terms of our insight into the subprime stuff, we didn't buy any subprime loans. I mean, we bought some securities, which we can go through, and we think we're fine in. We bought them for goal purposes. But we didn't buy in guarantee, essentially, any subprime loans. So we weren't in that business. So we think, given the business that we're in, a 10% price decline is pretty good. It's a pretty good number.

Now, you'll see numbers all over the place. And one thing I would invite anyone to do is just e-mail Freddie Mac and ask for a memo that we did, really, on housing price indices, because there are as many different housing price indices that have been constructed as there are economists. And if you were to take, for example, the Case-Schiller index, the Case-Schiller index-- And Chip Case is a good friend of mine. We used to work together. But that is based on 20 metropolitan areas heavily located in the east coast and the west coast with a high weight of over \$417,000 mortgages. So you can't compare that to our 10% forecast. Neither can you compare it to some other people's forecasts that are for the market as a whole, including the subprime and the jumbo market.

Finally, I saw-- I know the red light's flashing. I've got to get off. But Marty Feldstein, who also is a friend of mine, said something like - Well, housing prices could decline 30%. Let me tell you something. As I said, housing wealth in the United States is about \$22 [billion]. You get a 30% decline in housing prices; that's-- I said billion-- it's \$6.6 trillion. That's about half a year's GDP. If we get a decline in housing prices of 30% in the United States, we're all going long apples and boxes to sell them in.

James Fotheringham - Goldman Sachs - Analyst

Dick and Buddy, thank you very much. Most appreciated.

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