MEMORANDUM

Date: March 2, 2005

To: Dan Mudd

From: Adolfo Marzol

Subject: Private Label Securities

In late January, I became aware of issues regarding the existing limit on our purchase of private label securities, and since then have been gathering facts and working towards resolution. This memo seeks your guidance on next steps.

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Private Label Securities Portfolio Facts

- Total private label security balance grew to $116.1 billion as of YE 2004, up from $54.5 billion at YE 2003 and xx billion at YE 2002. This total includes securities held on balance sheet as well as "wraps" where we guarantee a private label security.
- Of the total, $80.6 billion is subprime and $25.3 billion is Alt A.
- The majority of the portfolio was acquired in 2004, when total new volume was $100.5 billion, primarily subprime and on-balance sheet. See Attachment A for a summary table of the private label portfolio and acquisition activity.
- Large 2004 private label volumes were necessary to achieve challenging minority lending goals and housing goals. Spreads also appeared attractive to Mortgage Portfolio.

Policy and Limit Facts

- The RPC approved a set of policies, procedures and delegated authorities last year for the risk management of private label securities.
- One of the concentration limits in the policy states "Total outstanding investment in private label securities may not exceed 10% of the total mortgage portfolio without approval of the Risk Policy Committee."

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- The policy contemplated that securities with lower levels of risk might be exempt from the limit. The policy allows for securities guaranteed by a AAA rated mono-line insurer (e.g. MBIA, FGIC) or securities with extra subordination ("super senior" bonds) equivalent to the protection afforded by a mono-line guaranty could be excluded at the discretion of the Chief Credit Officer. In August this authority shifted to the CFO or his designee, and most recently I am assuming this authority as interim CRO and Chair of the RPC.

- The outstanding investment at YE 2004 totals 12.8% of the mortgage portfolio with no exclusions. If we exclude all securities that have either a mono-line guarantee or a super senior structure the outstanding investment at YE 2004 totals 8.8% of the mortgage portfolio.

- In November of 2004 the RPC identified that without exclusions the 10% limit had been exceeded and temporarily waived the limit in order for Credit Finance to do some analysis on the risks and to recommend an approach to deciding which securities, if any, should be excluded from the limit. That work has been completed and can be used if we choose to revise the limit.

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Next Steps

- Peter Niculescu, Tom Lund and I met to discuss and recommend a strategy for our activity in this market for 2005. We should be ready shortly to discuss our conclusions and recommendations with you in more detail and obtain your guidance.

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- Despite the authority granted to the RPC, the size, strategic importance and risks of this portfolio (see risk summary in attachment B) have caused me to conclude that the strategy and any resulting limit changes be approved at a level more senior than RPC. RPC should meet and consider the matter and provide some input to a final decision.

I hope this background is helpful to you and allows you to be giving some consideration in advance of the appropriate levels of review and approval.

cc
Rob Levin
Peter Niculescu

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Tom Lawler
Tom Lund
Andy McCormick
Joe Biegel
Ramon Decastro
Kieran Gifford
Morgan Whitacre

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Risks:

- **Reliance on External Ratings:** The acquisition credit assessment of private-label securities investments relies predominately on external ratings. Although we invest almost exclusively in AAA rated securities, there is a concern that the rating agencies may not be properly assessing the risk in these securities. There have been enhancements made to monitoring the portfolio and in performing independent risk assessment on bonds that trigger certain performance or risk thresholds.

- **New Products and Risk Layering:** This market has been evolving, increasingly offering new credit terms such as IO, reduced documentation and increasing use of subordinated financing. These credit terms are being combined with more traditional subprime terms such as short fixed period ARMs, cash-out refinancing, non-escrowing for taxes and insurance and prepayment penalties. The combination of these risks may be difficult for subprime borrowers to understand at inception and to manage abrupt changes in family cash flows brought on by changes in the mortgage payment.

- **Home Price Cycle:** Over the past several years, home price appreciation has greatly exceeded long-term growth trends, particularly on the West Coast. Many subprime securities have high concentrations of loans in California and other high appreciation markets. Many of the loans in recent transactions would be susceptible to loss if home price growth rates were to slow or decline in these fast growing markets.

- **Servicing Procedures and Monitoring:** Each of the securities issued is governed by a unique set trust and servicing documents. Accordingly, the servicing of these loans does not follow Fannie Mae's Servicing Guides or operational controls. Furthermore, we do not have the same rights over servicing practices as we do in our standard business. At worst, in some circumstances it's possible that the servicers' interests may diverge from the best interests of senior bondholders. The SFMB has developed a team and process to monitor servicers and servicing practices, although there may be limitations to our ability to use some of the information learned in our risk analysis.

- **Deal Structures:** These transactions have complex cash flow allocation rules. These rules employ mechanisms such as triggers, excess spread, over-collateralization, and "shifting interest" structures to provide credit support for our securities investments. The structure is a critical element in the effectiveness of the credit support .

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