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*** "OFHEO Got Rolled" ***

"There is no dilutive capital raise planned." - Freddie Mac CFO Anthony S. Piszel (3/13/08)

The fact that the OFHEO announcement follows on the heels of only a couple of days of intensive dialogue, at the highest levels of the Administration, highlights that current concerns about the extreme fragility of the financial system are foremost in their minds. In fact, these discussions (as many of the recent actions by the Fed, Treasury and the Administration) have occurred without involvement of much of the staff and advisors that are usually involved in the Administration's decisions on GSEs. It is critical to remember however, that none of the actions have addressed the underlying problem of illiquid and unmarkable assets that continue to be stranded in the sixth level of purgatory.

To highlight the about face by various administration officials, OFHEO stated less than a month ago: "As each Enterprise nears the lifting of its Consent Order, OFHEO will discuss with its management the gradual decreasing of the current 30 percent OFHEO-directed capital requirement. The approach and timing of this decrease will also include consideration of the financial condition of the company, its overall risk profile, and current market conditions. It will also include consideration of the importance of the Enterprises remaining soundly capitalized to fulfill their important public purpose and the recent temporary expansion of their mission". We believe that OFHEO Director Lockhart took this action only after considerable pressure and likely against his best judgment. If this action results in the destabilizing of the GSEs, OFHEO will go from being the only regulator who had prevented their charges from getting into trouble to a text-book example of why regulators should be shielded from outside political pressure.

We view any reduction as a comment not on the current safety and soundness of the GSEs but on the burgeoning panic in Washington. Within the past 48-hours we have seen the Administration decide to throw out all the rules in the rulebook in an attempt to stabilize markets and reduce the risk of systemic contagion. While this approach will fuel optimism in the near-term, longer term we expect the OFHEO action and other recent actions to date to fail to achieve their goals. We also expect that the GSEs will use the extra capital to try and grow their way out of their problems by playing the spread instead of doing significantly more business in the higher credit risk markets.

In return for relief from at least a portion of the capital surplus the GSEs will be required to raise additional capital. Although the press has stated that capital would come in the form of preferred that was not stated in the OFHEO release. The GSEs have no specific regulatory limits to their preferred issuance but it has long been understood the rating agencies have warned that if more than 25% of GSE capital was in the form of preferred they would be at risk of downgrade. Given the increasingly routine forbearance by the rating agencies it is plausible they could get away with such a capital raising approach however we that the GSEs problems will likely increase the risk of the rating agencies downgrading the agencies only after they end up in more publicly obvious trouble.

Over the past 72 hours the Fed and the Administration have taken unprecedented steps to approach market instability. While many are viewing these actions as a positive sign, we continue to believe that they highlight that the building is shaking from the top to bottom and, unfortunately, would characterize these actions as short term positive to markets but unlikely to reverse the broader financial market problems for the medium and long term. Still, the view in the beltway is now "Desperate times call for desperate measures" even where the probability of the success of those measures cannot be estimated.

While it appears that the Administration has been rolled by the GSEs, and Democrats, we have been told that although no one is comfortable that the GSEs can ultimately manage their risks, sources tell us the Administrations is of the view that if desperate measures must risk either the GSEs or FHA, the Administration would rather risk the GSEs. More than one source has suggested that with less capital than they had a year ago and higher conforming limits, if one or both of the GSEs blew themselves up the Democrats would have been responsible for refusing to pass legislation with strong receivership authorities, bright lines on new products and programs and with strong portfolio limits.

We are in an environment where rumors are rampant so it may be worth offering two cents on a couple of rumors:

First, while most regional Fed officers would not support the Fed buying up the weak mortgage paper it has been considered and largely but not fully dismissed. However, it is an action that would not be taken lightly as it would cause many on the Hill to ask on what basis the Fed has been granted the right to make such budgetary decisions of consequence to taxpayers.

Rumors that repeatedly circulate suggesting Treasury will make the GSEs implicit guarantee explicit are obviously being circulated by those without a clear understanding of authorities, any such move would take an act of congress. While such a move could ultimately happen, given the possible future financial condition of the GSEs, we believe that it would not occur until after one or both GSEs were insolvent and Congress had to make a decision on how to stabilize them. Remember, only has the authority to choose to make the agencies explicit guarantees of the Federal Government.