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CONFIDENTIAL

MEMORANDUM

TO: James B. Lockhart III
Director, Federal Housing Finance Agency

FROM: Christopher H. Dickerson, Acting Deputy Director, Division of Enterprise Regulation

DATE: September 6, 2008

RE: Proposed Appointment of the Federal Housing Finance Agency as Conservator for the Federal Home Loan Mortgage Corporation

I. Introduction and Summary Conclusions

The Federal Housing Finance Agency ("FHFA") was established by the Federal Housing Finance Regulatory Reform Act of 2008, replacing the Office of Federal Housing Enterprise Oversight ("OFHEO") and the Federal Housing Finance Board as the regulator vested with the authority of supervising and regulating the government sponsored entities ("GSEs"): the Federal Home Loan Banks, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "the Enterprise").[1] [2] The Agency's examination program assesses the financial safety and soundness and overall risk management practices of Fannie Mae and Freddie Mac.

The GSEs are the nation's largest housing finance institutions. They buy mortgages from commercial banks, thrift institutions, mortgage banks, and other primary lenders, and either hold these mortgages in their own portfolios or package them into mortgage-backed securities for resale to investors. These secondary mortgage market operations play a major role in creating a ready supply of mortgage funds for American homebuyers.

[1] *See,* Housing and Economic Recovery Act of 2008, Pub. L. 110-289, 122 Stat. 2654 (the "2008 Act").

[2] For purposes of this Memorandum, the term "FHFA" or "Agency" will refer either to FHFA or its predecessor, OFHEO, as appropriate.

The financial condition of the Enterprise is vulnerable to continuing adverse business conditions, and management has not demonstrated the ability to implement effective corrective actions. Earnings, solvency, and liquidity are each negatively affected by current and forecasted credit losses, as well as the possibility of further impairments of private label securities ("PLS") and deferred tax assets ("DTA"). The critical unsafe or unsound practices and conditions that gave rise to the Enterprise's existing condition, the deterioration in overall asset quality and significant impairment in earnings throughout 2008 calls into serious question the ongoing viability of the Enterprise absent immediate financial assistance and renders it unable to fulfill its mission of providing stability and liquidity of the mortgage market. In light of the inability of the current Board of Directors and management to address adequately these concerns, I recommend that a conservator be appointed for the Enterprise before further deterioration in its condition can occur.

Pervasive and ongoing problems and deficiencies at the Enterprise that have contributed to my recommendation to appoint a conservator include:

(1) Given the Enterprise's risk profile, its capital levels are insufficient to support its business and to fulfill its important public mission. The Enterprise has no meaningful way to augment capital through earnings. The Enterprise had a generally accepted accounting principles ("GAAP") net loss of $3.1 billion in 2007 and has experienced GAAP net losses of almost $1 billion (before dividends) in the first six months of 2008. Given present market conditions, deteriorating housing price trends, continuing accounting issues, increasing counterparty and mortgage credit risk, increased cost of funding, and modeling problems, future earnings potential is non-existent for at least the next 18 months.

(2) The Enterprise's capital is inadequate and the quality of the capital base in the current environment runs contrary to generally accepted standards of prudent operation and, if continued, could result in abnormal loss or damage to the Enterprise. The Enterprise has acknowledged that it is unable to raise capital from private sources in the current market.

(3) Undue reliance upon DTA and other comprehensive income ("AOCI") to meet regulatory minimum capital requirements results in the Enterprise's reported capital being inadequate because such assets cannot be monetized and do not provide protection against substantial embedded credit losses not yet realized. Freddie Mac's core capital, when adjusted to remove intangible capital, is negative.

(4) Asset quality is poor and continues to deteriorate. Single-family delinquencies, credit related losses, and real estate owned ("REO") levels have increased dramatically. The private label securities ("PLS") portfolio has more than $30 billion in mark-to-market losses, and third quarter other than temporary impairments of investments in securities "OTTI") are likely to have a material adverse impact on earnings and capital.

(5) Deficiencies relating to credit governance and risk management, the conduct of the Chief Financial Officer, internal audit, capital management, portfolio management, and the non-Sarbanes-Oxley ("SOX") compliant internal control environment are

contrary to prudent operations and, if continued, would substantially weaken the Enterprise.

(6) Executive management is aware that models are not performing well in the current environment and has not devoted the resources necessary to address this problem. Given that key models have been functioning outside acceptable tolerances and are producing flawed outputs, the Board of Directors and executive management have relied on manual processes and extensive changes to models that are not subject to disciplined model change controls. This combination of problems makes the Enterprise vulnerable to errors, misjudgments, and possible manipulation and is an unsafe or unsound practice.

(7) Counterparty risk has been exacerbated at a time when financial institutions are under increasing stress. The widespread financial weakness of counterparties on which the Enterprise relies for credit enhancements, loan repurchases, portfolio servicing, effective default management and loss mitigation, derivatives, and other contractual safeguards cast doubt on the full collectability of potential obligations, thereby creating an unsafe or unsound condition to transact business. These weaknesses put the existing business model at risk.

(8) The strength, cohesiveness, and depth of the present executive management team is inadequate to cope with the severity and level of significant issues, as well as to fulfill their mission, and is a critical concern to FHFA. Key executive management positions remain unfilled, representing both a failure of the Board of Directors ("Board") and an abnormal risk to the Enterprise.

(9) The Board of Directors remains in continuing violation of the December 2003 Consent Order executed between the Enterprise and FHFA. Further, the Board of Directors has failed to comply with agreements reached with FHFA in March 2008 to raise significant levels of capital.

(10) The combination of serious internal weaknesses, including the Enterprise's failure to adhere to prudent underwriting standards, policies, and risk management practices, along with heightened public scrutiny as a result of current conditions, has materially increased the Enterprise's risk profile.

(11) Deteriorating market confidence in the Enterprise, as well as worsening market liquidity for GSE bullet and callable debt increased pressure on the Enterprise's discount note issuance program to a critical level. The Enterprise's liquidity plan of relying on repurchase ("repo" financing of its agency collateral to raise cash in the current credit and liquidity environment is an unsafe and sound practice or condition given the unavailability of willing lenders to provide secured financing in significant size to reduce pressure on its discount notes borrowings.

Based upon our findings in the mid-year review and the supervisory history of the Enterprise, I recommend that the Director immediately appoint the FHFA as conservator of the Enterprise for the following reasons:

- The Enterprise's unsafe or unsound practice or condition is likely to — (i) cause insolvency or substantial dissipation of assets or earnings or (ii) weaken the Enterprise's condition.
- The Enterprise is in an unsafe or unsound condition to transact business.
- The Enterprise has experienced substantial dissipation of assets or earnings due to unsafe or unsound practices.
- The Enterprise is likely to be unable to pay its obligations or meet the demands of its creditors in the normal course of business.

II. BACKGROUND

A. Historical Overview

Freddie Mac was established as a government-sponsored enterprise in 1970 to expand the secondary market for residential loans. Freddie Mac's activities are confined to the secondary mortgage market, and its current financial position and future prospects and ability to fulfill its mission, have been fundamentally impaired by the current housing market conditions.

B. Current Market Conditions

The overall conditions in the financial, mortgage and housing markets remain challenging for many mortgage market participants. The Enterprise is exposed to these markets directly through their guarantees of mortgage-backed securities and the mortgage-backed securities in their portfolio, and indirectly through their exposure to counterparty credit risk. Housing and mortgage market developments are crucial to Freddie Mac's financial stability.

From the end of 2001 through early 2007, the annual growth in house prices averaged 7% based on the OFHEO house-price index. This rapid increase in house prices was fueled by a number of factors on the demand side, which included strong economic fundamentals, relaxed lending standards, and some degree of speculation on future house price appreciation. On the supply side, the rapid increase in house prices resulted in increased new housing construction, with housing starts increasing from 1.6 million per year in 2001 to a peak annualized rate of 2.3 million in early 2006.

As now has become clear, relaxed lending standards, primarily in the subprime and Alt-A mortgage markets, led to a significant deterioration in credit quality that manifested itself through higher delinquencies and foreclosures. The focus of the subprime mortgage market is on borrowers who have had some prior credit problems. As of the end of 2007, the foreclosure rate on subprime mortgages originated between 2004 and 2006 was about 4% for fixed-rate mortgages and nearly 10% for ARMs. Mortgages originated in 2005 performed worse than mortgages originated in

2004; mortgages issued in 2006 performed slightly better, but it is projected that their performance will worsen with time as ARMs originated in 2006 reset. In the first quarter of 2008, 6.4% of outstanding subprime ARMs and 2% of outstanding subprime fixed rate mortgages began the foreclosure process.

The Alt-A mortgage market focused on borrowers with better credit history than the subprime market, but is based on mortgages with little or no documentation of key factors such as income and assets. The default rate on Alt-A mortgages originated between 2004 and 2006 was 2% for fixed-rate mortgages and 3% for ARMs. As in the subprime market, performance is worse in later vintages.

As conditions deteriorated in the subprime, and subsequently the Alt-A, markets, the rising inventory of foreclosed homes, along with a general tightening of credit, put considerable downward pressure on house prices. These factors, along with a general slowing of the economy, eventually resulted in the deterioration spreading to the prime mortgage market. In the first quarter of 2008, 1.5% of outstanding prime ARMs and 0.3% of outstanding prime fixed-rate mortgages started foreclosure. In the preceding 5 years, the average foreclosure start rates for prime ARMs and fixed-rate loans were 0.30% and 0.15%, respectively.

It is difficult to predict with any certainty when the current housing correction will end. New housing construction has fallen dramatically from a peak annualized rate of 2.3 million in January 2006 to 965,000 in July 2008. But the remaining new home inventories and increased foreclosures have led to large increases in housing inventory. As of the first quarter of 2008, the current housing inventory stands at about 10 months' supply at current sales rates, which is up significantly from the historical average of about 6 months' supply. Measures of the decline in house prices vary widely, from 5% using the OFHEO index, to 17% using the Residential Property Index ("RPX"), to 19% using the Case Shiller Index. The RPX index, which is based on 25 Metropolitan Statistical Areas, is the most actively traded property derivative. Current forward prices on the RPX index imply that we are only half way through the correction in housing prices. Further declines in house prices are likely to place additional pressure on overall mortgage credit quality as the incentive for homeowners to walk away from their mortgages payment increases.

As the assets underlying Freddie Mac's guarantee and investment portfolios have deteriorated, the cost of raising capital for the Enterprise has risen. During the past two months, the deterioration in the GSEs' borrowing conditions has accelerated, creating market conditions hostile to private-market capital-raising. Freddie Mac common stock have lost nearly three-fourths of their value since the end of June. These factors make it difficult, if not impossible, for the Enterprise to raise significant quantities of capital from the private market.

C. Past Agency Examinations of the Enterprise

During the past few years, the Enterprise has experienced pervasive material weaknesses in its governance and enterprise risk management (including credit risk, market risk, and operational risk). The Agency has placed the Board and management of the Enterprise on notice of these material weaknesses through, among other things, reports of examination ("ROEs"), risk assessment reports, meetings with the Board, conclusion letters, and other supervisory and regulatory guidance. On December 9, 2003, the Board entered into a Consent Order (the "2003

Consent Order") that, among other things, contained articles related to (1) cooperation with the Agency; (2) the Board of Directors and senior management; (3) internal controls; (4) internal audit; (5) internal accounting; (6) risk management transactions; and (7) public disclosure and regulatory reporting. The Enterprise remains in non-compliance with the 2003 Consent Order.

Examinations in 2005, 2006, and 2007 highlighted the Agency's continuing concerns with the Board's and management's oversight and operation of the Enterprise, serious deficiencies in credit risk management at a time when the Enterprise was acquiring riskier assets, and capital and liquidity plans which could, in the event of market turmoil, become stressed. In 2006 and 2007, the Agency gave the Enterprise a composite rating of "3" (with "1" being the highest rating and "5" the lowest) on its CAMELSO ratings system. The Agency replaced this ratings system on January 1, 2008, with a combined ratings methodology of GSEER: Governance, Solvency, Earnings, and Enterprise Risk (Credit, Market, and Operational). Issues and concerns at the Enterprise are discussed below, for organizational purposes only, according to this methodology.

1. Governance

FHFA has repeatedly raised serious concerns with the critical weaknesses in, Board of Director's and management oversight and conduct. In many instances, despite repeated warnings, the Board and management have failed to correct the deficiencies. The Enterprise's board and management have failed to ensure the safety and soundness of the Enterprise, correct deficiencies identified in ROEs and other supervisory correspondence, and fully comply with the 2003 Consent Order. The Director met with the Board of Directors on several occasions during the last year to discuss these issues. Many of these and other issues were discussed in the Director's monthly meetings with the Chairman of the Board and the Chief Executive Officer, Richard F. Syron.

The Enterprise has failed to comply with the 2003 Consent Order by failing to separate the positions of Chairman of the Board and Chief Executive Officer. It is important to keep these positions separate in order to avoid potential conflicts of interest. In addition to failing to hire a CEO, the Board has failed to retain a qualified President and Chief Operating Officer and to maintain a viable succession plan. The Agency also noted that the acrimony between the General Auditor and Chief Financial Officer resulting in the resignation of the General Auditor, reflects poorly on executive management, could undermine the effectiveness and independence of the internal audit department, and is the source of significant supervisory concern. The lack of a complete executive management team, combined with the failure of the Board to maintain an effective succession plan and the inter-management tensions, during this period of tumult in the housing finance sector has exposed the Enterprise to increased undue risk.

Management also displayed extensive weaknesses in the credit risk management area. As discussed in more detail under Credit Risk, recent ROEs have criticized the use of increased risk layering, contract provisions precluding simultaneous price increases commensurate with increased risk, MIS weaknesses, and the failure of the Enterprise to have engaged a Chief Credit Officer. The Centerline transaction, also discussed in Credit Risk, is a further example of management compromising internal controls, failing to act in a transparent manner, and ignoring prudent risk management practices in an apparent desire to meet year-end housing goals and get the deal done.

In addition, as discussed below, management has failed to address the liquidity needs of the Enterprise through adequate liquidity contingency planning. Earlier indications that the Enterprise had planned adequately to address its liquidity needs have proven to be false in light of subsequent events.

2. Solvency

In January 2004, the Agency imposed a capital surcharge of 30% of the minimum capital surplus due to increased operational risk. The 2006 ROE emphasized the importance of maintaining a capital surplus in excess of the directed requirement, given continued operational weaknesses. The Enterprise submitted a minimum capital report and letter stating that for the month-ending November 30, 2007 it failed to meet its 30% surplus requirement by approximately $1.9 billion. This deficiency occurred after a "near miss" in October and a failure in September to raise the authorized preferred stock. The 2007 ROE warned that certain internal accounting changes implemented by the Enterprise, while providing short-term capital relief, risked long-term negative consequences to earnings and capital.

In March 2008, the Agency reduced the 30% surplus requirement to 20% based upon a commitment from the Enterprise's Board and management, at the time of the agreement, that it would raise significant additional capital and maintain capital levels well in excess of regulatory minimums. After many months of further negotiations, the Board agreed to raise a minimum of $5.5 billion through a combination of 50% common stock and 50% asset-driven preferred. To date, the Enterprise's Board and management have failed to comply with this agreement, and have not raised the capital necessary given the current risk profile of the Enterprise. Asset quality is poor and continues to deteriorate. Single family serious delinquencies, credit-related losses, and REO levels have dramatically increased. The Enterprise's PLS have more than $30 billion in mark to market losses, and third quarter 2008 impairment charges are likely to have a material adverse impact on the Enterprise's earnings and capital.

The continued high exposure from both market and credit-related risks places pressure on the Enterprise's capital base, dangerously eroding capital levels as losses continue. Current and projected earnings remain insufficient to maintain the capital base through normal operations. Not surprisingly, capital projections have been repeatedly revised downward, raising concerns over capital sufficiency in 2009 and the long-term viability of the Enterprise.

Additionally, the Enterprise's DTA have increased from $4.3 billion in the first quarter of 2007 to approximately $18.4 billion in the second quarter of 2008. This increase in DTA, coupled with the uncertain market conditions, has heightened FHFA's concern appreciably about the quality and recoverability of this tax benefit, calling into question a major portion of core capital. Most importantly, although DTA currently represents approximately one half of the Enterprise's core capital, in the current environment <u>none</u> of this amount is available to absorb losses. If core capital were adjusted using the bank regulatory definition, which limits DTA to 10% of capital, the Enterprise's core capital would be about $20.5 billion, well below the Enterprise's statutorily required capital level and approximately equivalent to the Enterprise's risk-based capital requirement. As a result, the current core capital number presents a distorted and unrealistic picture of the Enterprise's true financial condition and ability to survive in the current marketplace.

Aggravating this situation, deteriorating market confidence in the GSEs, as well as the worsening market liquidity for GSE bullet and callable debt, has increased pressure on the Enterprise's liquidity risk management programs and practices. This lack of market confidence resulted in the Treasury proposal to potentially provide funding and capital to the GSEs. The Enterprise's ability to convert unencumbered collateral to cash and to sell assets successfully from its Liquidity & Contingency ("L&C") portfolio during periods of extreme market illiquidity has been adversely impacted during recent months, as management did not want to risk signaling to the market a need to improve liquidity and increase cash-equivalents. This demonstrates that the Enterprise's liquidity plan is no longer viable and imposes an abnormal risk to the Enterprise. Failure to have adequate liquidity policies, procedures and systems is an unsafe or unsound practice.

3. Earnings

Over the past three years, the Agency has warned the Enterprise repeatedly that its credit underwriting and credit risk management standards were insufficient in light of changes in the Enterprise's asset portfolio reflecting, among other things, increasing purchases of riskier mortgage loans. The Agency also warned that these deficiencies were symptomatic of broader internal control weaknesses. The Agency admonished the Enterprise to correct these deficiencies, warning that if they continued they would have an increasingly negative impact on earnings.

The Enterprise has experienced net losses of $972 million in the first six months of 2008. Earnings during this period have been adversely impacted by increasing credit-related expenses, substantial fair value losses on the trading portfolio, and OTTI impairments on PLS. As the Agency had warned, forecasts of future earnings have been repeatedly revised downward, as projections of credit-related expenses continue to rise substantially. FHFA currently estimates that the low range for losses in 2008 is $11 billion and the high range for such losses is $32 billion.

Notwithstanding the dominance of credit-related expenses in earnings forecasts, future earnings are also exposed to fair value losses from widening spreads of PLS, and other than temporary impairments on those assets. Taken with credit-related losses, these results are likely to cause a substantial dissipation of earnings and assets due to unsafe or unsound practices.

4. Enterprise Risk Management

a. Credit Risk

During 2006, credit risk increased as the Enterprise undertook more aggressive underwriting initiatives including the purchase of untested and nontraditional mortgage products. On July 12, 2006, the Agency warned the Board and management in the first-quarter 2006 Risk Assessment Letter that the Enterprise's current risk management infrastructure did not fully address and mitigate the incremental risks associated with non-standard business and untested products. In the third-quarter 2006, Risk Assessment Letter, the Agency cautioned that recent acquisitions of nontraditional mortgages had increased the risk profile, as demonstrated by an expected doubling of default costs since year end 2005. Moreover, the Agency also expressed concerns that the Enterprise's inability to implement requisite risk management and control capabilities to address weaknesses in internal controls, information technology, and modeling would present serious challenges to the financial condition of the Enterprise.

Deficiencies in credit risk management and underwriting continued to build in early 2007. However, as the Agency had warned, the weaknesses were not yet evident in the Enterprise's performance. Focusing on then-current performance of the Enterprise, as opposed to the long-term implications of its control weaknesses, the Board of Directors and management made -- and continues to make -- little progress in correcting long-standing weaknesses. In fact, the Enterprise's purchase of asset-backed mortgage securities, especially PLS backed by subprime and Alt-A mortgages, has greatly increased its credit risk.

These continuing weaknesses in managing credit risk resulted in significant losses in 2007. The 2007 ROE again warned that the purchase of loans with weak underwriting had adversely impacted, and would continue to adversely impact, financial results, flexibility, and the overall strength of the Enterprise. The Agency's warnings were clearly justified by the Enterprise's actions. The absence of risk-based pricing in 2006 and 2007, and ignoring repeated regulatory warnings, created a situation that has resulted in contractual provisions that preclude simultaneously increasing pricing commensurate with the increased risk. As predicted by the Agency, the Enterprise has been adversely effected by continued and significant deteriorating single-family performance indicators, rapidly growing credit losses, and market pressures that are expected to further negatively impact the Enterprise's performance, including earnings and capital, for the foreseeable future. Again reflecting these warnings and concerns, the Agency rated credit risk as "Significant Concerns" at the end of the first quarter of 2008.

The December 2007 Centerline $2.8 billion TEBS (tax exempt bond securitization) transaction is a prime example of management ignoring prudent credit-risk administration and management practices. Indeed, this transaction highlights continued weaknesses in multiple critical areas -- governance, internal controls, credit risk, model risk and accounting. It serves as an example of a management philosophy that appears to value completing the transaction over ensuring that proper risk management is in place and financial viability is established first. This transaction was an unsafe or unsound practice for several reasons. Among them are the following:

- To the extent the transaction represented a bailout of Centerline, a key Multifamily counterparty for the Enterprise, it constituted an improper use of the franchise and exposed the Enterprise to reputation risk.

- Use of an accelerated new product approval process was inappropriate for a transaction of this size, complexity and risk. Transaction review and approval processes were inconsistent with internal controls. Accounting policy related to TEBS was investigated only after closing, and surfaced the need for an unforeseen change impacting the balance sheet.

- Financial evaluation and risk analysis were woefully inadequate when the transaction was initially approved.

- Potential conflicts of interest may have arisen as a result of the failure to identify all parties benefiting from the transaction.

- Pre-closing due diligence underwriting was inadequate given the amount, condition and location of properties. Management operated under the unproven assumption that credit risks could be mitigated with the credit support and structure. The adequacy and appropriateness of models used to determine the credit support and structure could not be established.

Further exacerbating the Enterprise's condition, the credit governance structure and management information systems failed to keep pace with deteriorating credit quality. Despite repeated criticisms from the Agency, the Enterprise continues to operate without key management and operational personnel, including a Chief Credit Officer, a Chief Operating Officer and an Enterprise-wide Credit Committee. Operating with vacancies in these key management positions is contrary to generally accepted standards of prudent operation that has continued and subjects the Enterprise to abnormal risk of loss. Thus, it is an unsafe or unsound practice.

b. Market Risk

Through ROEs and other supervisory correspondence and guidance, the Agency repeatedly warned the Enterprise that a change in market conditions would call into question the Enterprise's liquidity contingency planning. One example of an area of Agency concern is the Enterprise's ability to convert unencumbered collateral to cash and to sell successfully assets from its L&C portfolio during periods of extreme market illiquidity. This ability was severely compromised during recent months, as Enterprise management did not want to signal to the market a need to improve liquidity and increase cash-equivalents.

Mortgage market conditions are so weak that significant mortgage backed securities ("MBS") sales from the Enterprise retained portfolio to raise cash would likely trigger significant decreases in MBS prices and widening mortgage rate spreads. Continued widening in spreads will create GAAP losses in the trading portfolio and fair value losses in the AFS portfolio, further weakening the Enterprise's already precarious capital position. Deficiencies in the Enterprise's modeling practices have had a pervasive negative impact on the Enterprise. Model risk has been a significant concern for some time. At least as far back as the 2005 ROE, the Agency warned that the Enterprise's model risk governance required substantial improvement. The Agency called upon the Enterprise to upgrade governance practices and model development and to control and enhance the quality of independent model risk oversight. In the third-quarter 2006 Risk Assessment Letter, the Agency specifically targeted the lack of sufficient model oversight as a "significant deficiency".

Model risk currently remains high due to the wide application of models in business decisions and financial reporting and the magnitude of the dollar amounts affected. The level of model risk has been increased by the unprecedented environment in which the company will be operating for the foreseeable future. Management is aware that models are not performing well in the current environment, yet it has not devoted sufficient resources to address the problem. Given that key models have been functioning outside acceptable tolerances and are producing flawed outputs, management has relied on manual processes and extensive changes to models that are not subject to disciplined model change controls or may not be implemented in a timely manner. This combination of problems makes the Enterprise vulnerable to errors, misjudgments and possible manipulation, and is an unsafe or unsound practice.

For example, the current single family loan loss reserve model was the subject of an examination that was completed in early 2007. Numerous changes necessary were as outlined in the exam conclusion letter. A more general finding was that the approach does not conform to best or even current practice in its use of granular (i.e. state/local) information in estimating loss events. The Enterprise has proposed a new model, but has continued to delay its implementation.

c. Operational Risk

As a result of a higher credit risk profile, operational risks related to personnel, technology and reporting became more apparent. The Agency repeatedly warned the Enterprise's Board and management that its operational risk was high and it continues to be an area of primary supervisory concern.

The 2003 Consent Order required the Enterprise to establish effective internal controls with respect to the Board and executive management, including financial reporting, internal accounting, internal audit, and risk management oversight. Weaknesses in internal controls have persisted since the Consent Order. The 2004 ROE expressed concern that its independent auditor, PricewaterhouseCoopers ("PwC"), had identified material weaknesses and internal control deficiencies during its audit of the financial statements for the year ending December 31, 2003, and that additional material weaknesses were identified in 2004. The ROE warn that a significant amount of work remained for the Enterprise to become compliant with the Consent Order.

The Agency highlighted internal controls as a matter requiring attention ("MRA") in both the 2005 and 2006 ROEs. In the 2005 ROE, the Agency stated that strengthening and improving internal controls surrounding financial, managerial, and regulatory reporting processes along with the planned changes in enterprise risk management, data processing, and operational practices were necessary. Fundamental changes in enterprise risk management, data processing, and operational controls also were deemed to be necessary before the Enterprise could self-identify and remediate widespread control weaknesses. The ROE warned that existing control deficiencies, if not addressed, could develop into material weaknesses. The 2007 exam again criticized internal controls as ineffective, concluding that operational risk management required improvement.

The Agency also has repeatedly criticized continuing weaknesses in information technology, data quality, and internal controls. In the 2006 ROE, the Agency cautioned that weaknesses continued in information technology systems development and delivery, information security, end-user computing systems, data quality, and change management. In the second-quarter 2008 Risk Management Letter, the Agency admonished that the Enterprise's systems are inflexible and do not easily adapt to changing business needs. This forces the Enterprise to rely on manual processes and controls (workarounds and data handoffs) to handle the changes in volumes and products.

III. CURRENT CONDITION OF THE ENTERPRISE

In its 2008 mid-year review, FHFA rated the Enterprise "Critical Concerns," the lowest GSEER rating. This rating and reflects a conclusion that critical safety and soundness problems exist with the Enterprise. The Enterprise is vulnerable to continuing adverse business conditions, and management and the Board of Directors have not demonstrated the ability to implement effective corrective actions. Given the critical unsafe or unsound practices and conditions that gave rise to the Enterprise's existing condition, the deterioration in overall asset quality and significant impairment in earnings threatens the Enterprise's capital base.

This rating reflects a downgrade from the prior quarter and stems from the continued and significant deterioration in credit quality in both the credit guarantee and retained portfolios, ongoing weakness in credit governance, concerns related to the capacity of the present management team and Board of Directors to resolve current issues, use of outdated models to inform decisions, weak financial performance, and less than a fully effective internal control environment, including the internal audit function. Additional OTTI of PLS and the likely potential of not fully realizing DTA are a concern. A significant lack of market confidence has eliminated the ability of the Enterprise to raise a significant amount of capital from the private sector at the present time.

As a consequence of a series of ill-advised and poorly executed decisions and other serious misjudgments, the Enterprise's poor financial performance, expected negative future earnings and loss expectations, inadequate capital position, and an inability to rely fully on representations made by the Board of Directors and management to the Agency, FHFA has lost confidence in the Board of Directors and the senior executive management team. This is particularly true given the delay and lack of transparency demonstrated by executive management in addressing repeatedly communicated regulatory criticisms and recommendations. Moreover, the Agency is increasingly concerned that the same management team responsible for the Enterprise's current condition is also charged with overcoming the many challenges the company now faces as the result of that condition. This task may be seriously compromised by executive management's demonstrated and continuing apparent unwillingness and/or inability to implement necessary corrective actions within an acceptable time frame.

The underlying unsafe or unsound practices at the Enterprise have caused and are likely to continue to cause a substantial dissipation of assets and earnings and cause the Enterprise to be in an unsafe or unsound condition to transact business. Management has allowed its capital base to deteriorate substantially in the past months, dangerously reducing the capital resources available to the Enterprise to absorb losses embedded in its existing portfolio and credit guarantee book. This condition is further exacerbated by the fact that almost one-half of the Enterprise's core capital is comprised of DTA, an intangible asset that is incapable of being monetized. The Enterprise is clearly vulnerable to substantial further deterioration in capital given the current conditions in the mortgage market. The mid-year review stressed that the Enterprise suffers from the following problems, many of which are of long standing, despite repeated FHFA warnings:

A. Governance

Governance is rated "Critical Concerns." Governance comprises Board and management actions, accounting, compensation, compliance, enterprise wide risk management, external audit, internal audit, management, reputation and strategy. The critical concerns rating reflects FHFA's determination that more than moderate weaknesses and unsafe or unsound practices or conditions exist. Ongoing issues of significant concern include:

1. The Board of Director's Failure to Separate the Positions of Chairman of the Board and Chief Executive Officer

After nearly five years, the Board of Directors continues to be in violation of Article II, paragraph 13 of the, 2003 Consent Order. The Board has failed to separate the position of the Chairman of the Board and the Chief Executive Officer within a reasonable period of time. Notwithstanding repeated expressions over the past 55 months of its commitment and specific plans to satisfy this requirement, the Board has not separated these positions, and has broken several agreements with the Director on complying with this written commitment. Failure to separate these positions is contrary to generally accepted standards of prudent operation.

2. Board's Failure to Retain a Qualified President & Chief Operating Officer

The Board of Directors is responsible for hiring and retaining qualified senior executive officers to conduct the company's affairs, and to maintain an appropriate succession plan for executive officers. In May 2007, the Enterprise announced that President and Chief Operating Officer Eugene McQuade would leave the Enterprise in September 2007. It has now been over a year since the Enterprise announced Mr. McQuade's exit, and the Board of Directors still has not filled this key position. The inadequacies of executive management during this period of tumult in the housing finance sector has unduly exposed the Enterprise to abnormal risk of loss. The combined failure of the Board to fill this important position and to maintain a viable succession plan is an unsafe or unsound practice.

3. Board's Failure to Address Identified Matters Requiring Attention

Failures in Board oversight are evidenced by the large number of outstanding MRAs. For example, there are 46 currently outstanding MRAs covering Internal Controls, Credit Risk Management, Compliance with OFHEO's Mortgage Fraud Reporting Regulation, and Governance. The majority of the MRAs currently are overdue.

4. Management Weaknesses in Credit Risk Management

Enterprise management of credit risk has been a source of ongoing concern, which the Director first raised to the Board in June 2006. More recently, the 2007 ROE warned of a market deterioration in credit quality -- a reflection of market developments, pursuit of housing mission goals, and management's strategic decision to purchase and guarantee certain single family ("SF") mortgages originated in 2006 and 2007 with higher-risk characteristics including: interest-only products, loans with secondary financing, mortgages with FICO scores less than 660, and loans with higher loan-to-value ratios. Evidence of increased risk layering has also been uncovered. Contract provisions precluded simultaneously increasing pricing commensurate with the increased risk. Also cautioned were concerns with Management Information Systems ("MIS") and the failure of the Enterprise to operate without a Chief Credit Officer. In 2006, the Agency informed the Enterprise of its conclusions that the expansion of the subprime PLS portfolio outpaced the attendant risk management structure, and that the weaknesses in risk management rendered the Enterprise "vulnerable to unidentified and latent risk" in the portfolio. However, management continued to replace run-off with new purchases into 2007 averaging approximately $22 billion per quarter. Had management stopped purchasing these securities concurrent to the issuances of the Agency's conclusion letter, the vast majority of the $193 billion retained ABS portfolio would have run-off by now.

The failure to exercise appropriate credit risk discipline is an unsafe or unsound practice that has caused the Enterprise to be in an unsafe or unsound condition to transact business. Weaknesses in credit risk management are discussed further under the heading "Credit Risk Management".

5. Management Failure to Maintain Adequate Liquidity Contingency Planning

The Enterprise's practice of relying on repo financing of its agency collateral to raise cash in a systemic liquidity event is an unsafe and sound practice or condition given the unavailability of willing lenders to provide secured financing in significant size. Management failed to ensure that the company could convert unencumbered agency MBS to cash through secured lines of credit or an active repo funding program.

For example, the Enterprise's 90-day liquidity policy was designed to make sure that under extreme stress, *i.e.*, no access to the discount note market, the Enterprise would be able to borrow from the market using its agency collateral. Today, given stressed credit and liquidity conditions, market lenders are not willing to issue term-repos or to commit secured lines to the Enterprise in significant size. As a result, the Enterprise is in an unsafe or unsound condition to transact business. Liquidity deficiencies are discussed more fully below under "Market Risk".

6. Failure to Raise Capital

The Board and executive management failed to raise capital despite the March 19, 2008 agreement with the Agency, as they were reluctant to honor their commitment to raise "significant capital," especially any common equity. Management pursued several months of discussions with the Agency before coming forth with a proposal to raise $5.5 billion, half in common equity, that was accepted by the Board of Directors. The Enterprise's failure to raise new capital immediately following the agreement now has placed it in a market of heightened debt, equity and mortgage market uncertainty, raising grave doubts about its ability to complete the proposed $5.5 billion capital raise or otherwise to raise additional capital. These doubts have been confirmed by the marketplace as private investors have indicated a lack of interest in investing in the Enterprise without government backing. The Enterprise was hoping a private equity investment could anchor a comprehensive and significant capital raise, which now appears highly unlikely or cost prohibitive. The failure of the Board of Directors and executive management to anticipate and act on capital needs or to position the Enterprise to raise needed capital in a down economic market has placed the Enterprise in an unsafe or unsound condition to transact business.

The CEO's explanations for this failure emphasize factors that were just as relevant in March 2008, when the Board of Directors committed to raise capital. In fact, they invite the conclusion that the Board and Chief Executive Officer did not deal with the FHFA Director in good faith in making this commitment, which the Board and management knew would, and which did, contribute strongly to the Agency's decision at the time to reduce the capital surcharge at the time of the agreement. In a June 13, 2008 letter, the Agency urged Chairman and Chief Executive Officer Syron to move expeditiously to meet its commitment, and criticized the Board of Directors and management for continuing to grow the portfolio without first raising capital as promised. Growing the Enterprise's portfolio against this background was an unsafe or unsound practice that has caused the Enterprise to be operating in an unsafe or unsound condition to transact business.

7. Accounting

FHFA has significant continuing concerns regarding the Enterprise's application of GAAP, based upon our analysis, findings, and observations. These concerns are exacerbated by the fact that the economic environment in which the Enterprise operates has continued to deteriorate. The incidence of mortgage loan-related delinquencies and foreclosures has increased dramatically, and the Enterprise's large investments in mortgage-related securities have continued to decline in value at an accelerated pace.

FHFA continues to have concerns with the large amount of losses deferred in accumulated other comprehensive income ("AOCI") as they represent potential losses that would be realized if the investments needed to be liquidated at once. These losses have continued to grow since June 30, 2008. Moreover, the large amount of losses deferred in AOCI have a negative implication for the quality of the Enterprise's statutory capital. In this same connection, FHFA has significant concerns regarding OTTI. There has been a serious reluctance on the part of the Enterprise to take OTTI write-downs despite clear signals from the market that losses are likely. Only after the Agency threatened to issue a cease-and-desist order, did management agree to write down to market securities in the long-term liquidity portfolio.

A recent example of this reluctance to take OTTI was management's hasty reversal of an impairment decision just prior to the issuance of the second quarter financial statements that served partially to offset liquidity portfolio losses. This involved bonds insured by XLCA. In this instance, management elected not to impair several bonds insured by XLCA despite significant uncertainties regarding XLCA's claims-paying ability and below investment grade credit ratings. The decision, which served partially to off-set the long-term liquidity portfolio write-down, was based on a pending transaction that was expected to improve claims-paying ability, although the extent of the impact was far from clear, as evidenced by the rating agencies "wait and see" approach. Management reversed its initial decision to impair, despite serious reservations expressed by the Agency regarding both the financial soundness of the insurer and the potential reputation risk to the Enterprise.

The continuing failures of the Board of Directors and management has raised serious concerns about the continuing safety and soundness of the Enterprise. These failures are unsafe or unsound practices and have caused the Enterprise to be operating in an unsafe or unsound condition to transact business.

B. Solvency

Solvency is rated "Critical Concerns." Solvency evaluates the quantitative measurement of available capital in relation to the risks facing the Enterprise, the sufficiency of capital planning, and other capital management tools in light of the risks and future capital requirements. A "Critical Concerns" solvency rating indicates that actions taken to manage day-to-day capital adequacy place continued pressure on the Enterprise's long-term ability to ensure adequacy. Earnings are not sufficient to support the augmentation of capital. Sources of additional capital are constrained and impact the ability of the Enterprise to react and respond to changing risks and market conditions in a timely and cost-effective manner.

Although the Enterprise reported that, as of June 30, 2008, it satisfied the statutory definition of "Adequately Capitalized," upon examination, FHFA believes that there are significant weaknesses in the Enterprise's financial condition that make clear that, particularly based on events from and after June 30, 2008, the Enterprise's capital is insufficient and that the quality of the capital base in the current environment constitutes an unsafe or unsound condition to transact business. Moreover, the quality of the Enterprise's capital is weakening rapidly to the point that the ongoing viability of the Enterprise is in question absent immediate financial assistance, as a result of:

- substantial declines in the price of the company's common and preferred stock;
- increasing reliance on preferred stock for equity capital relative to common stock;
- aggressive application of certain accounting principles;
- loss reserves and counterparty exposures, especially mortgage guarantee insurers ("MIs") exposure to existing and future business;
- substantial increases in AOCI, which is not reflected in the statutory definition of core capital for regulatory purposes. Large negative AOCI amounts reduce shareholders' equity even though it does not impact core capital as measured by the statutory definition; and
- undue reliance upon DTA which has increased from $4.3 billion in the first quarter of 2007 to approximately $18.4 billion in the second quarter of 2008, representing approximately one half of the Enterprise's core capital.[3]

Additional factors impacting the Solvency rating include, but are not limited to:

- The Board of Directors' and executive management's failure to date to raise additional capital totaling a minimum of $5.5 billion, as previously committed to the Agency. This failure is an unsafe or unsound practice that has placed the Enterprise at a significant disadvantage to raise the needed capital given the uncertainty and pricing in the market. Private equity investors are indicating that the risks are too high at this point, and there are no indications of when, the Enterprise could successfully return to the equity markets.

- The continued high exposure from both market and credit-related risks place pressure on the capital base of the Enterprise, further eroding the core capital surplus as losses continue. Current and projected earnings capacity remains insufficient to grow the capital base through normal operations.

- Weakening market confidence in the Enterprises continues to place pressure on liquidity.

- Capital projections, while continuing to demonstrate surpluses over current minimum requirements, have been repeatedly revised downward, raising concerns over capital adequacy.

The preceding factors, and unsafe or unsound practices, taken together, have caused the Enterprise to be operating in an unsafe or unsound condition to transact business.

C. Earnings

Earnings is rated "Critical Concerns." This rating comprises all aspects of earnings and financial analysis including the soundness of the business model, adequacy of earnings to build and maintain capital, and the quality of earnings. The rating of "critical concerns" reflects FHFA's assessment that immediate fundamental changes are necessary to address the issues evaluated and concern that the Enterprise is unable to implement corrective actions in the current environment. Earnings generally have declined over the past five years and were most recently driven by increased credit costs. The Agency has previously issued supervisory letters identifying concerns related to the Enterprise's earnings.

The Enterprise has experienced net losses of approximately $1 billion in the first six months of 2008. Earnings during this period have been adversely impacted by increasing credit-related expenses, substantial fair value losses on the trading portfolio, and OTTI impairments on PLS. Forecasts of future earnings have been repeatedly revised downward, as projections of credit-related expenses continue to rise substantially. Notwithstanding the dominance of credit-related expenses in earnings forecasts, future earnings also are exposed to fair value losses from spread widening of PLS.. Future earnings are threatened by a massive overhang of unrealized losses on AFS securities that may convert into security impairments. These results demonstrate on a current basis and prospectively, a substantial dissipation of earnings and assets due to unsafe or unsound practices.

Other factors resulting into the "Critical Concerns" earnings rating include the following:

- The Enterprise's net losses available to common shareholders in the first half of 2008 were $1.5 billion.

- The provision for credit losses at $3.8 billion for the first half of 2008 is 31% higher than the full year 2007 amount of $2.9 billion. Future provision requirements would further depress earnings.

- Retained earnings do not account for potential future losses which are embedded in AOCI ($24.2 billion), DTA (total exposure of approximately $18.4 billion as of the second quarter of 2008); future expected credit losses not yet reserved for and substantial remaining OTTI and MI exposure.

- The Enterprise's own base-case earnings forecast would result in a thin capital cushion by year-end 2009. The matter is complicated further by the fact that the forecasting process has one outstanding MRA. Thus, capital in the base-case forecast is at substantial risk of eroding much faster than indicated in the projections.

Based on the foregoing, reflecting significant shortcomings and weaknesses in internal controls and risk management practices, FHFA has determined that the Enterprise's financial condition has deteriorated to the point where the Enterprise is in an unsafe or unsound condition to transact business.

D. Enterprise Risk Management (Includes Credit Risk, Market Risk, and Operational Risk)

Freddie Mac's credit management, organization structure, decision-making, systems, controls and models are not capable of adequately handling credit risk in this stressed environment.

1. Credit Risk Management

Credit risk is rated "Critical Concerns." This component is comprised of an evaluation of accounting, counterparty, credit models, multifamily, portfolio credit, and single family and incorporates both the quantity of risk in the Enterprise and the quality of risk management in these areas. The rating of "critical concerns" reflects FHFA's assessment that immediate fundamental changes are necessary to address the issues evaluated and concern that the Enterprise is unable to implement corrective actions in the current environment. Data, models, systems, and risk management practices do not and have not fully accommodated the growing levels of complex and higher risk products, which is an unsafe or unsound practice.

The "Critical Concerns" rating reflects a downgrade from "Significant Concerns" in the first quarter of 2008. The worsening rating is due to weak internal credit controls and risk management, as demonstrated by:

- Management's failure and refusal to take more than limited proactive measures to improve overall credit governance practices, despite <u>repeated</u> urgings by the Agency.

- The Enterprise is operating without a Chief Credit Officer and with credit-related internal management information systems and risk management processes that are not commensurate with the characteristics and condition of the portfolio. These failings were discussed on several occasions with the Chief Executive Officer and the Board and reflect ongoing unsafe or unsound practice that continues to put the Enterprise in an unsafe or unsound condition to transact business.

- The absence of a corporate-wide Credit Committee.

- The absence of timely risk-based pricing in 2006 and 2007 has created a situation that has resulted in contractual provisions precluding simultaneously increasing pricing commensurate with the increased risk.

The failure to have an adequate credit risk governance structure in place likewise raises concerns about the Enterprise's ongoing safety and soundness.

The adverse effect of these shortcomings has been compounded by continued and significant deteriorating single-family performance indicators, rapidly growing credit losses, declining financial capacity of MIs and financial guarantors, financial weakness of significant servicers, and market pressures that are expected to stress Enterprise performance, including earnings and capital, for the foreseeable future.

Further, the amount by which the lifetime expected losses related to credit exposures exceeds the GAAP credit loss reserves has increased alarmingly.

a. Single Family Credit Risk

The quantity of risk is high as evidenced by rapidly rising levels of credit losses and significant adverse changes in performance indicators. Delinquencies, REO, and credit losses have risen substantially during this quarter and year-over-year. Moreover, the loan loss reserve for the second quarter of 2008 has increased by more than five-fold since the second quarter of 2007, signifying the Enterprise's acknowledgement and continued expectation of rapidly deteriorating credit conditions. Current market conditions, including continued rapid declines in housing prices, double-digit levels of excess housing supply, and a cycle of loan resets that are expected to peak in 2010 continue to put considerable stress on credit performance.

Credit losses (defined as net charge-offs and REO operations expense) in the first six months of 2008 were \$1.338 billion, a sharp rise from \$137 million in the first six months of 2007. Equivalent credit loss ratios have risen from 1.7 bp to 14.5 bp. The Single-Family Operating Committee projected full-year 2008 credit losses to be \$3.209 billion, more than six times 2007 levels of \$495 million. These trends are likely to result in a substantial dissipation of earnings and capital. Compounding this dire situation is the fact that REO loan recovery at disposition is tracking downward rapidly; in June 2008, REO loan recovery at disposition was 77.8%, versus 83.0% in March 2008, and 91.3% for 2007.

Significant declines in house prices and rising levels of housing supply continue to pressure serious delinquency rates and levels of REO. Year-over-year serious delinquency rates more than doubled from 0.42% in the second quarter of 2007 to 0.93% (excluding structured transactions) in the second quarter of 2008 and 1.01% in July. Alt-A mortgages are leading contributors to serious delinquency rates and credit losses. The Enterprise continues to promote alternatives to foreclosure and has piloted several new loss mitigation initiatives. The volume of workouts is up almost 40% in the second quarter of 2008 to 17,415 from 12,480 one year earlier. However, REO inventories continue to rise substantially as inflows exceed dispositions. At the conclusion of the second quarter of 2008, there were 22,029 properties in REO inventory, more than double the REO inventory levels at the conclusion of the second quarter of 2007 at 10,260. An estimated 52,754 REO properties will be acquired in 2008 high REO acquisition states including California, Arizona, Michigan, Virginia, Florida and Nevada — areas with higher than national average inventories or regional economic challenges.

Negative expectations for future credit performance and losses and ultimately for earning and capital levels are demonstrated by the rapidly rising loss reserve. In the second quarter of 2008 management recommended a single-family loss reserve of $5.8 billion, compared to $1.1 billion for the second quarter of 2007, an increase of more than five-fold reflecting the deterioration in the credit markets. Projected credit related expenses, including the loan loss provision and REO operations expense for 2008 is $7.987 billion.

The deterioration in overall credit is the result of unsafe or unsound practices that have put stress on the existing credit governance structure and have caused the Enterprise to be in an unsafe or unsound condition to transact business. The business unit has only recently begun efforts to strengthen its credit management reporting, including reporting information on portfolio and purchase information; performance results and asset disposition; top counterparty and exposure detail; credit loss drilldown; profitability and return analysis; segment earnings; forecasts; and a comparison of actual versus planned performance. The failure to have such structure in place previously raises concerns about the Board's and management's attention to the Enterprise's ongoing safety and soundness and has caused the Enterprise to be operating in an unsafe or unsound condition to transact business.

b. Multifamily ("MF") Credit Risk

Risk in the MF business is increasing due to rising cap rates and property level expenses, and slower rent growth. Increasing expenses and cap rates combined with slower rent growth may lead to a decline in apartment values. Enterprise research suggests that cap rates are likely to increase in excess of 125 bp over the next few years from 6% to 7.25%, which could lead to a drop in property values between 10 and 15%.

The% of the portfolio on the critical and high Watchlist has remained flat at 0.4% since August 2007. There was a credit gain in April of $143,000 bringing the year to date credit loss total to approximately $0.4 million. Credit losses are expected to increase slightly from their historical lows. Delinquencies decreased to 3 bp, consisting of two 60-day delinquent loans totaling $20 million.

c. Centerline

The Centerline transaction, as discussed in detail above, highlights continued weaknesses in multiple critical areas -- governance, internal controls, credit risk, model risk and accounting.

An apparent desire to meet year-end housing goals cannot serve as a justification for engaging in an unsafe or unsound transaction, compromising internal controls and ignoring prudent risk management practices.

d. Counterparty Risk is Increasing Rapidly

Counterparty risk is growing very rapidly at a time when financial institutions are under increasing stress. The widespread financial weakness of counterparties on which the company relies for credit enhancements, repurchases of substandard loans, portfolio servicing, effective loan management and loss mitigation, derivatives, and other contractual safeguards creates an unsafe or unsound condition to transact business.

The rating agencies have downgraded most MIs and many of the financial guarantors that are Enterprise counterparties. As of the end of the second quarter of 2008, the Enterprise's risk in force to MIs was $65 billion, and its exposure to financial guarantee insurers was $11 billion. The Enterprise continues to rely heavily on expectations of substantial recovery from the MIs despite widespread concerns about their financial stability. Four MIs were downgraded to below the AA- trigger level. Triad was terminated as an approved MI and is currently in run-off mode. As a result of the downgrades, PMI, Radian, and MGIC have initiated their approved remediation plans and are being actively monitored by the Enterprise. Rating agencies continue to downgrade the MIs, making it challenging for them to raise much-needed capital.

FHFA is concerned the MIs may not have sufficient capital and reserves to meet their commitments of first loss coverage wherein the Enterprise's recoveries would decline and credit losses would increase. The eroding financial condition of the MIs also may impact negatively the Enterprise's ability to continue to purchase product in accordance with its charter guidelines. Declining levels of reserves and capital at the MIs could result in reduced levels of business reflecting an inability or reluctance by the MIs to underwrite or insure product with loan to value ratios ("LTVs" greater than 80%. Moreover, the Enterprise's subprime PLS portfolio is backed by financially weak monoline insurers. While the Enterprise is responding to these downgrades with closer monitoring and protection of exposures where possible, the risk of losses, directly impacting the Enterprise's capital position, remains a matter of deep concern.

In addition, significant servicers are experiencing financial strain which exposes the company to disruptions in the servicing of portfolios. The Enterprise cannot efficiently and cost-effectively transfer large servicing portfolios because there is an inadequate number of experienced servicers in a position to take over the servicing.

Finally, the Enterprise has had to increase its derivatives counterparty limits due to the limited number of suitable counterparties. This rapid growth is caused by volatile markets and the inability to fund themselves with any significant amount of medium or long-term callable debt. Given the size of the Enterprise, it is reasonable to expect that there will continue to be a limited number of suitable counterparties. The further deterioration of MIs, seller-servicers and derivative counterparties threatens Freddie Mac's business model. To the extent that this action results in an excessive number of transactions with the remaining available counterparties this concentrated exposure could constitute an unsafe or unsound practice that would result in the Enterprise being in an unsafe or unsound condition to transact business.

2. Market Risk Management

Market risk is rated "Critical Concerns." This component is comprised of an evaluation of accounting, interest rate, liquidity and market models. and incorporates both the quantity of risk in the Enterprise and the quality of risk management in these areas.

The overall program for Market Risk is rated "Critical Concerns." The subordinate risk ratings for liquidity risk and portfolio management risk are "Critical Concerns" while the subordinate rating for interest rate risk is "Significant Concern."

a. Retained Mortgage Portfolios

At June 30, 2008, the non-agency portfolio had unrealized losses of about $30 billion on a portfolio of $212 billion, all of which is held as AFS yet the Enterprise recognized only $826 million non-agency securities impairment for the second quarter of 2008 The Enterprise does not model impairments at a loan level and uses a single CPR/Loss severity curve per asset type. Further, significant credit downgrades of the bonds in the PLS portfolio (currently $8.6 billion below investment grade) may be indicative of further impairment.

In addition, the Enterprise's capital surplus may not be sufficient to absorb large changes in the value of the Enterprise's $159.6 billion mortgage-related securities classified as "trading" due to the risk of MBS spread widening, which the Enterprise does not hedge. For example, a 50 basis point widening in MBS spreads would decrease capital by about $3 billion, approximately 9% of the Enterprise's reported core capital as of June 30, 2008.

With the lifting of the retained portfolio cap in March 2008, the Enterprise grew its Retained Portfolio by approximately $73 billion during the second quarter of 2008. Second quarter growth provided above-average projected returns driven by attractive option adjusted spreads assuming credit assumptions do not prove to be unreliable. However capital constraints and illiquidity in long term debt markets will likely limit future growth.

b. Liquidity Risk Management is Poor

Deteriorating market confidence in the Enterprise as well as worsening market liquidity for GSE bullet and callable debt increased pressure on the Enterprise's discount note issuance program to a critical level. The Enterprise's almost exclusive reliance on discount note funding is a critical concern. In addition, this lack of market confidence in GSE funding resulted in the Treasury proposal, and Congressional approval, for Treasury to potentially provide funding and/or capital to the GSEs.

Weekly auction pricing of discount notes are at historically wide levels versus Treasury bills (though less historically wide when compared to LIBOR and swaps). Continued deterioration in market confidence could lead to failure of a weekly auction that would trigger an increase in headline risk and further erosion of investor confidence in GSE debt.

Similarly, deterioration of scheduled monthly pricing of long-term Benchmark Notes could lead to a failure of monthly Benchmark Note issuance that also results in reputational risk and a further erosion of investor confidence in GSE debt. This further lack of confidence could trigger significant sales of the Enterprise's debt, push down prices on GSE debt, and effectively cut off the Enterprise's already very limited ability to issue longer-term debt.

Callable issuance of medium-term debt has also decreased significantly. This lack of investor interest impacts both liquidity and also interest rate risk management as callable issuance is a key component of the management practices at the Enterprise, specifically the repurchase of options to offset the mortgage portfolio's short option positions. As a result, the usage of derivvatives and therefore counterparty risk is growing rapidly.

And finally, mortgage market conditions are so weak that significant MBS sales from the Enterprise's retained portfolio to raise cash would likely trigger significant decreases in MBS prices and increase mortgage rates offered to consumers. The magnitude of this consumer impact is significant as option adjusted spreads on TBA MBS are already at historically high levels and incremental sales could widen mortgage rates 25-50 basis points or more. Continued widening in spreads will create GAAP losses in the trading portfolio and fair value losses in the AFS portfolio, further weakening the Enterprise's capital position.

c. Liquidity-related Safety and Soundness Concerns

The Enterprise's liquidity management practices are critically inadequate and unsafe or unsound because management failed to: ensure that the Enterprise could, in the current environment, convert unencumbered agency MBS to cash through secured lines of credit; create an active repurchase funding program or outright sales of MBS; designate the L&C portfolio as held-for-trading; and ensure adequate cash management reporting.

For example, the Enterprise's 90-day liquidity report was designed to make sure that under stress, i.e., no access to the discount note market, that the Enterprise would be able to borrow from the market using its agency collateral to raise more that $100 billion to cover 90 days of net cash needs. Today, given stressed credit and liquidity conditions, market lenders are not willing to issue term-repos or to commit secured lines to the Enterprise in the size needed by the Enterprise.

On January 1, 2008, the Enterprise decided not to include its L&C assets in a held-for-trading account against the express urging of FHFA. During July 2008, the Enterprise resisted selling long-term L&C assets because of the potential embedded losses until FHFA forced the Enterprise to take OTTI on that portfolio (by threatening an cease-and-desist order).

During the second quarter of 2008, the Enterprise's cash management report did not include $8.8 billion of possible contractual cash outflows associated with liquidity facilities provided by the MF business area. An FHFA cash management examination identified this potential cash outflow and the Enterprise amended its cash management report to include this significant liquidity contingency.

The Enterprise does comply with FHFA's request to manage its net cash needs to ensure that it has cash or cash equivalents to last 30 calendar days without access to the discount note market. Furthermore, the Enterprise relies on its ability to use the TBA mortgage market to fund prior commitments by rolling its commitments to future moths. If the TBA mortgage market becomes stressed, however, the Enterprise's economic costs to role these significant positions will increase.

d. Interest Rate Risk Raises Significant Supervisory Concerns

Extreme market volatility, ongoing model updates and estimated risk positions close to management limits raised significant supervisory concerns in second quarter of 2008. During the quarter, management risk limits, including PMVS-L, Vega and peak convexity were breached on several occasions. Although the asset, liability, management ("ALM") desk successfully brought these risk positions in line with management limits following approved policies and procedures, the occurrences were more frequent than previous quarters.

Despite two earlier adjustments, the Enterprise's prepayment models continue to overstate prepayments for conventional fixed rate products relative to actual prepayments. Although the Enterprise's prepayment models are slower than other Street benchmarks, the ALM team and the modeling group expect to further slow down the conventional fixed rate models. The Enterprise also plans to change its mortgage current coupon model in the third quarter. Combined, these model changes will extend duration by $100 billion with minimal impact on convexity and Vega exposures. This model change, and the PLS on-top adjustment, raise significant supervisory concerns about the reliability of the interest rate risk metrics, notwithstanding that the PLS on-top adjustment was reasonable and well documented.

The Enterprise has continued to increase its short convexity and Vega exposures during the second quarter. Increased purchases of fixed rate mortgages and decreasing option repurchases due to high option prices contributed to this net increase in option exposure. Although these risks remain within management and Board limits, their increase has complicated the work of duration management in this volatile market environment.

e. Model Risk

As the foregoing discussion indicates, deficiencies in the Enterprise's modeling practices have had a pervasive negative impact on the Enterprise.
Model risk has been a significant concern for some time. For example, the 2005 ROE cautioned that model risk governance requires improvement to upgrade governance practices and model development and to control and enhance the quality of independent model risk oversight. In the third-quarter 2006 Risk Assessment Letter, the Agency specifically identified the lack of sufficient model oversight as a "significant deficiency". Model risk remains high due to the wide application of models in business decisions and financial reporting and the magnitude of the dollar amounts affected. The level of model risk has been increased by the unprecedented environment in which the company will be operating for the foreseeable future. Management is aware that models are not performing well in the current environment and has not devoted sufficient resources to address this problem. Given that key models have been functioning outside acceptable tolerances and are producing flawed outputs, management has relied on manual processes and extensive changes to models that are not subject to disciplined model change controls or may not be implemented in a timely manner. This

combination of problems makes the company vulnerable to errors, misjudgments, and possible manipulation and is an unsafe or unsound practice.

Resources to document model changes adequately are limited. At a recent count, the number of model changes scheduled was 47. The result is pressure to approve model changes without the controls called for by Enterprise policy. Alternatively, model changes that correct poorly functioning models are delayed. An example is replacement of the Single-Family Loan Loss Reserve ("SF LLR") system that has been delayed for three quarters. This issue has been raised in meetings with Model Oversight and with the business unit. Most recently, the Enterprise's Operations Risk Oversight has raised this issue to senior management.

The current SF LLR model was the subject of an examination that was completed in early 2007. Numerous necessary changes are documented in the conclusion letter. Most important are the manual nature of data updates; the use of end user computing for calculating accounting carve-outs; the lack of transparency as to the cause of losses and their concentrations within the portfolio. A more general finding was that the approach does not conform to best or even current practice in its use of granular (i.e. state/local) information in estimating loss events. A new model is proposed and under development to address these shortcomings, but has been significantly delayed. Other model risk concerns include:

(1) Model Inventory and Flow Charts – When model risk began examining the Enterprise, there was no model inventory and no documentation of the interaction among the models. An inventory now exists, but it is deficient in that new models are still being identified (e.g., SF Costing) and added. Further, there is still no description of model interaction for the vast majority of models.

(2) OTTI for PLS — The model used to evaluate OTTI impairment for PLS is not estimated at the loan level and does not model collateral.

(3) Independence of model development staff-- Model governance fails to have adequate segregation of duties, e.g. model development staff were deeply involved in Centerline transaction negotiations.

(4) Outdated Credit Risk Models – Until last month, the Enterprise's key guarantee-fee pricing and valuation model, Defcap, was 3 years out of date. the Enterprise continues to base earning scenarios on this model which it believes under predicts loss severities and was not intended for the purpose of evaluating seasoned loans with delinquency histories.

(5) Changing Risk Metrics - Interest rate metrics are subject to high degree of model risk in this environment. The historically used PMVS measure was discontinued in the first quarter of 2008 due to a sharp erosion of the fair value of equity. Between 2007 and 2008 the Enterprise's Board of Directors, based on the recommendation of management, decided to increase interest risk exposures at a time when credit costs were escalating.

(6) An economic capital model - in the process of development - was used to support significant expansion of the portfolio and calculate returns for the portfolio. The economic capital model was changed when it began to show that required economic capital exceeded available capital. In other words, the Enterprise shifted to a new measure when the existing measure would have required a capital raise or reduction in risk. The model encourages growth of portfolio rather than prudent management of risks.

(7) The Enterprise does not have data to track exposure to servicers in PLS. On the other hand, management has mishandled impairments of PLS where company has the data and employed very optimistic prepayment and loss severity curves (the Enterprise ignored data and acted on uninformed management judgment instead).

(8) Management continues to base earning scenarios on a model it believes under-predicts loss severities and was intended for the purpose of evaluating seasoned loans.

In short, the problems with the Enterprise's modeling constitute unsafe or unsound practices that result in the Enterprise being in an unsafe or unsound condition to transact business.

3. Operational Risk Management

Operational risk is rated "Significant Concerns." This component evaluates accounting, financial reporting, information technology, internal controls, and operational models. The Significant Concerns rating reflects FHFA's determination that more than moderate weaknesses and unsafe or unsound practices or conditions exist. This has been an area of identified weakness for several years.

a. Information Technology is Outmoded

Although there has been evidence of improvement in the Enterprise's IT governance processes and functions, the Enterprise's systems are inflexible and do not easily adapt to changing business needs. As a result, the Enterprise relies on manual processes and controls (workarounds and data handoffs) to handle changes in volumes and products.

In early 2008, the Enterprise's management determined that the material weaknesses related to Systems Development Life Cycle ("SDLC") and information security were remediated. However, management also identified and disclosed four significant deficiencies related to SDLC and information security. Management believes that the two significant deficiencies related to the SDLC were remediated as of June 30, 2008; however, this has not been validated.

b. Data Quality Remains of Concern

During the last twelve months, the Enterprise recognized that data quality problems are symptoms of deeper systems and infrastructure problems. This resulted in a significant re-orientation of the Enterprise's approach to addressing data quality.

The new data quality approach focuses around data architecture, the use of data models and services, and the importance of data quality metrics. The Enterprise's executive management recognizes the (1) need to address data quality in the application and system design processes (by ensuring that applications contain automated edit checks when delivered), (2) the need to give users the ability to correct and update data directly (with all the appropriate permissions and auditing trails) and (3) that Data Correction Utilities cannot serve as replacements for that functionality.

The Enterprise has presented an "Information Roadmap", which is a plan that addresses many of these issues. Risks now reside with plan execution. Initial steps related to the plan (including the creation of a geo-coding service and revision of data quality policies and standards) are promising.

However, despite the Enterprise's assertions that there have been measurable improvements in the quality of the Enterprise's data, they do not have a set of data quality metrics in place that would provide management with an understanding of the Enterprise's most basic data quality problems.

c. Board and Management Have Allowed Internal Controls to Remain Ineffective

Internal controls are not considered effective. Despite years of claimed effort the Enterprise is not SOX compliant and independent testing of reportedly remediated controls has not been completed. The E2E (end to end) design documentation and analysis effort is still not completed after major project "course corrections" in 2006 and 2007. This demonstrates that project management and senior management direction have not been effective, and the Board has permitted this condition to continue. Recent design reviews by PWA show approximately 800 detailed comments/ issues outstanding about the control design. Certain E2E work streams (including debt and derivatives and loan loss reserve) have not completed even the initial E2E documentation effort. Managers and staff are not held accountable for results, related to the E2E project. Numerous internal project deadlines have been missed since 2004, with very few repercussions for management and staff.

d. Operational Risk Management Oversight) is Inadequate

The Enterprise-wide operational risk management function continues to be developed. The recent resignation of Gareth Davies creates a void in this key leadership position. Although a foundation for the program is in place, all necessary risk management tools such as operational risk assessments are not fully functioning. Disaster recovery planning is not complete and has been cited as a deficiency for a number of years. The continuing failure to have adequate disaster recovery planning in place constitutes and unsafe or unsound practice that results in the Enterprise being in an unsafe or unsound condition to transact business.

IV. FACTUAL BASIS FOR CONSERVATORSHIP GROUNDS

A. Unsafe or Unsound Practices

The Enterprise has engaged in numerous unsafe or unsound practices. Board and management oversight and operation of the Enterprise has been, and continues to be wholly inadequate. The Enterprise does not have a sufficient level of capital commensurate with its risk profile, and it has failed to raise additional capital, in spite of an agreement with the Agency to do so. Despite repeated urgings from FHFA, management failed to correct numerous deficiencies in internal controls related to credit and market risk management and governance practices. As a result of increasing credit risk in the Enterprise's portfolio earnings have decreased, with the Enterprise recognizing losses of approximately $1 billion in the first six months of 2008. In addition to mounting losses and insufficient capital relative to its risk profile, the Enterprise's liquidity position has become stressed, as the Board and management have failed to implement an adequate liquidity contingency funding plan.

B. Unsafe or Unsound Condition

The practices described throughout the discussion above, which are contrary to generally accepted standards of prudent operation, have placed the Enterprise into an unsafe or unsound condition to transact business. Because of the poor quality of the Enterprise's assets, weak credit administration, risk management practices, wholly inadequate Board and management oversight, dissipation of the Enterprise's earnings and capital is likely to continue. Loan loss reserves must be augmented. Without positive earnings, DTA are valueless and loan loss provisions must come from capital, which is inadequate, and as the Enterprise has acknowledged, it is unable to raise capital from private sources in the current market.

Liquidity is strained and options to increase overall liquidity are limited. The Enterprise's liquidity plan is not workable under current market conditions. The Enterprise's prolonged reliance almost exclusively on 30-day discount notes is an untenable long-term source of funding and an unsafe or unsound practice that poses abnormal risk to the viability of the Enterprise. Operating without an adequate liquidity funding contingency plan is an unsafe or unsound condition to transact business.

Given the above, and the Enterprise's risk profile, its capital levels are insufficient to support its business. The Enterprise has no meaningful way to augment capital through earnings or private sources. Continuing to operate with insufficient capital is an unsafe or unsound condition to transact business.

As a result of the myriad of unsafe or unsound practices and conditions, as detailed above, the Enterprise is subject to an abnormal risk of loss and is in an unsafe or unsound condition to transact business. Indeed, these unsafe or unsound practices and conditions call into question the ongoing viability of the Enterprise absent immediate financial assistance.

C. Inability To Meet Obligations

As described throughout the discussion above, the Enterprise has engaged, and continues to engage, in numerous unsafe or unsound practices. Also as described above, the Enterprise is in an unsafe or unsound condition to transact business. As a result of these practices, the Enterprise has lost approximately one billion dollars during the first six months of this year. In addition, because of the poor quality of the Enterprise's assets and the systemic unsafe or unsound practices, the Enterprise's losses are likely to continue. As a result, the Enterprise's ability to pay its obligations as they become due is subject to serious question.

D. Impact

As described more fully above, the Enterprise has engaged in numerous unsafe or unsound practices that have resulted in substantial dissipation of assets or earnings, including approximately one billion dollars in losses during the first 6 months of this year. A high level of losses is likely to continue into the foreseeable future. FHFA currently estimates that the low range for losses in 2008 is $11 billion and the high range for such losses is $32 billion. This level of losses resulting from prior unsafe or unsound practices or conditions represent a further significant dissipation of assets and earnings for the Enterprise.

Moreover, the condition of the Enterprise has been severely weakened. Its asset quality, capital levels, and liquidity funding options are severely deficient. The ongoing viability of the Enterprise, absent immediate financial assistance, is a serious concern.

VI. CONCLUSION

Pursuant to 12 U.S.C. § 4617(a)(3), the Director may appoint a conservator for the Enterprise if certain conditions exist. Based on the facts described above, I reach the following conclusions relevant to those grounds, based upon the facts and conclusions set forth above and the supervisory record as a whole:

- The Enterprise's unsafe or unsound practice or condition is likely to — (i) cause insolvency or substantial dissipation of assets or earnings or (ii) weaken the Enterprise's condition.

- The Enterprise is in an unsafe or unsound condition to transact business.

- The Enterprise has experienced substantial dissipation of the assets or earnings due to unsafe or unsound practices.

- The Enterprise is likely to be unable to pay its obligations or meet the demands of its creditors in the normal course of business.

For these reasons and as discussed above, the immediate appointment of a conservator is recommended.