



Fannie Mae and Freddie Mac 2Q08 Results; Balance Sheets Hide Strong Fundamentals

On August 6 and August 8, respectively, Freddie Mac and Fannie Mae released their second quarter results. Four weeks earlier, the market capitalizations of the two companies went into accelerated decline after a sell-side analyst suggested that a possible interpretation of a proposed accounting rule change could render the companies insolvent. Three weeks earlier the Secretary of the Treasury had to quickly convene a Sunday press conference to quiet a market wary of the US government's support. And just a week earlier, Congress passed and President Bush signed the Housing and Economic Recovery Act of 2008, which codifies that support. Suffice it to say that as the companies reported, the market was skeptical, and they did not disappoint in their ugliness: Slashed dividends and sizeable losses related to significantly higher loan loss provisions and worsening credit experience. (Summary financial and operating statistics are set forth at the end of this note.) Despite the ugliness, we believe the worst fears of the marketplace are misplaced, for the challenges to the balance sheet hide strong income fundamentals, an aggressive loss provisioning discipline and the rights and privileges that accrue to companies with near-explicit government support.

Specifically on the numbers, Freddie Mac reported a loss of \$821 million, or \$1.63 per diluted share, due primarily to a \$2.5 billion provision for future credit losses, which was more than double the provision from the first quarter, about equal to the provision made during all of 2007 and almost nine times the provision made in all of 2006. The loan loss reserve now stands at \$5.8 billion, or 30 basis points on assets. Seriously delinquent loans (90 days late or in foreclosure) rose to 104 basis points from 88 basis points in the first quarter. Credit losses totaled \$810 million, or .00173% of assets, up from \$528 million or .0012% of assets. "The credit deterioration has largely been driven by the continued decline in home prices and other declines in regional economic conditions..." said Freddie Mac in its earnings release.

Fannie Mae reported a \$2.3 billion loss in the quarter, or \$2.54 per diluted share, due primarily to a \$5.1 billion provision for credit losses, about 60% bigger than in the first quarter, a bit more than all of 2007 and almost nine times the provision made for 2006. Actual credit losses were \$1.2 billion, or .00175% of assets, up from \$880 million or .00126% of assets. Seriously delinquent loans rose to 136 basis points from 115 basis points in the first quarter. Daniel Mudd, Fannie Mae's CEO, put performance in context: "Volatility and disruptions in the capital markets became even more pronounced in July. In addition, credit performance has continued to deteriorate and, based on our experience in July, we anticipate further increases in our combined loss reserves."

Compounding the problems are all the measures of capital that are presented by the companies—GAAP book value, Fair Value book value, Regulatory Core Capital—and no matter how it's measured, it appears meager. As far as the companies' current regulator, OFHEO, and future regulator, FHFA, are concerned they are adequately capitalized, holding regulatory core capital in excess of their minimum 20% capital surplus charge. Nevertheless, both companies are being strongly urged to continue to preserve and raise new capital, and both announced that they would



be cutting third quarter common stock dividends to a nickel. Freddie announced it remained committed to raising \$5.5 billion in new money.

Lost in the headlines is the fact that the income-generating fundamentals for the two companies are strong. The yield curve is steep and guarantee fees are generally rising. In the quarter, Fannie Mae generated net interest income and guarantee fee income totaling \$3.7 billion, less administrative expenses of \$512 million, for a total of \$3.2 billion in operating cash flow to cover credit losses (which again, came in at \$1.2 billion). Freddie Mac generated net interest income and guarantee fee income totaling \$2.3 billion, less administrative expenses of \$404 million, for a total of \$1.9 billion to cover credit losses (which totaled \$810 million for the quarter). Thus both companies are easily covering expenses and the current period effects of credit losses. Moreover, the companies are provisioning like mad to stay ahead of losses. Fannie Mae and Freddie Mac have each been provisioning far in excess of their net charge-offs in recent periods (likely with significant encouragement from regulators), as well as in excess other banks. As the table below illustrates, in the last quarter Fannie and Freddie have provisioned over five and four times their charge-offs, more than other banks. Fannie's and Freddie's loan loss reserve covers their current annualized run rate of charge-offs by 2.4x and 2.7x, respectively.

	<u>Provision/Net Charge-offs</u>				1Q	2Q
	2004	2005	2006	2007	2008	2008
Freddie Mac	102.1%	281.7%	201.4%	974.1%	387.5%	465.5%
Fannie Mae	167.6%	95.5%	129.7%	224.6%	487.8%	538.1%
Wells Fargo	103.1%	104.4%	97.8%	139.6%	132.7%	199.2%
Wachovia	85.7%	120.3%	118.6%	232.6%	370.1%	425.3%
Citigroup	72.5%	112.7%	95.2%	168.2%	151.3%	159.9%
JP Morgan	147.9%	190.1%	180.1%	203.7%	267.8%	201.2%
US Bancorp	92.0%	97.2%	100.0%	100.0%	165.5%	150.5%
Bank of America	89.0%	57.3%	110.4%	129.4%	221.4%	161.1%

Unfortunately, the increased size of their provisions is more than offsetting the positive effects of rising guarantee fees and the favorable yield curve. So what combination of rising default rates, loss severities and capital position would press the companies into tapping the capital lines established by the Act? In a recent piece (“Note on the Housing and Economic Recovery Act of 2008,” August 6, 2008, <http://www.annaly.com/NHERA2008.pdf>), we ran the back-of-the-envelope math on Freddie Mac after it released second quarter numbers, and calculated that a 4% default rate and a 40% loss severity would lead to lifetime losses of \$29 billion, compared to regulatory capital of \$37 billion. In the slide deck accompanying its earnings release, Freddie Mac provided more granularity to this type of potential loss analysis, which we reprint below. The first set of tables shows the company's assessment of the losses over the lives of its prime portfolio under different default rate and severity assumptions—broken down by year of origination and in total. Notice the default rate assumptions are worse in the more recent vintage. Prime constitutes 89.7% of the company's unpaid principal balance:



(\$ in Billions)					
Prime Portfolio (2005 & Prior¹) Nominal Lifetime Default Cost					
Severity Rate					
		30%	35%	40%	
Default Rate	1	1%	\$3	\$3	\$4
	2	2%	\$6	\$7	\$8
	3	3%	\$9	\$10	\$11
4 Balance (UPB \$ billions) ² \$949					
5 % Seriously Delinquent ³ 0.74%					
Prime Portfolio (2006 & After¹) Nominal Lifetime Default Cost					
Severity Rate					
		30%	35%	40%	
Default Rate	3	3%	\$6	\$8	\$8
	4	4%	\$8	\$10	\$11
	5	5%	\$10	\$12	\$14
Balance (UPB \$ billions) ² \$898					
% Seriously Delinquent ³ 1.00%					
Prime Portfolio Nominal Lifetime Default Cost					
Severity Rate					
		Low	Med	High	
Default Rate	Low	\$9	\$11	\$12	
	Med	\$14	\$17	\$19	
	High	\$19	\$22	\$25	
Balance (UPB \$ billions) ² \$1,647					
% Seriously Delinquent ³ 0.82%					

Next Freddie Mac presented estimates for lifetime default costs of its Alt-A portfolio—broken down by the worst 20% performers and the remaining 80%—under more draconian default rate and severity rate assumptions. Notice how the default and severity assumptions are worse among the worst Alt-A performers, which total just \$38 billion. The whole Alt-A portfolio accounted for 10.3% of the company’s unpaid principal balance (for comparison, Fannie’s Alt-A portfolio is about 12% of its book of business). The rationale for the higher default rate and severity rate assumptions is proven out by actual results. According to Freddie Mac, 79% of the loss increase from 1Q08 to 2Q08 was due to the Alt-A portfolio.

Alt-A Portfolio (Worst 20%⁴) Nominal Lifetime Default Cost					
Severity Rate					
		40%	45%	50%	
Default Rate	6	30%	\$4	\$5	\$6
	7	40%	\$6	\$7	\$7
	8	50%	\$8	\$9	\$10
9 Balance (UPB \$ billions) ² \$38					
10 % Seriously Delinquent ³ 11.41%					
Alt-A Portfolio (Remaining Percent) Nominal Lifetime Default Cost					
Severity Rate					
		35%	40%	45%	
Default Rate	5	5%	\$3	\$3	\$3
	8	8%	\$4	\$4	\$5
	10	10%	\$5	\$6	\$7
Balance (UPB \$ billions) ² \$152					
% Seriously Delinquent ³ 2.20%					
Alt-A Portfolio Nominal Lifetime Default Cost					
Severity Rate					
		Low	Med	High	
Default Rate	Low	\$7	\$8	\$9	
	Med	\$10	\$11	\$12	
	High	\$13	\$15	\$17	
Balance (UPB \$ billions) ² \$190					
% Seriously Delinquent ³ 3.72%					

Last, the company summed it all up by low, medium and high cases for the entire portfolio, which shows that the range of potential lifetime credit costs going forward is from \$16 billion to \$42 billion and that the estimate we made in our recent paper was about the same number as the medium default rate and medium severity rate case:

Total Portfolio Nominal Lifetime Default Cost				
		Severity Rate		
		Low	Med	High
Default Rate	Low	\$16	\$19	\$21
	Med	\$24	\$28	\$31
	High	\$32	\$37	\$42
Balance (UPB \$ billions) ²		\$1,837		
% Seriously Delinquent ³		1.04%		



Freddie Mac points out that these tables are for indicative purposes only, do not reflect the company's view on the likelihood of any potential outcome and actual results may differ substantially from these scenario results.

On August 11, 2008, Standard & Poor's downgraded the preferred stock and subordinated debt rating of Fannie Mae and Freddie Mac to A-. The downgrades reflect "the greater subordination risk to these securities, as [Fannie Mae/Freddie Mac] now operates under a new regulatory regime." The Agency also lowered the companies' "risk-to-the-government" rating to A. The "risk to the government" rating measures the companies' credit quality absent any extraordinary government support, as if they were stand-alone entities (kind of like a "risk of no government" rating).

At the same time, S&P affirmed the senior debt ratings of Fannie Mae and Freddie Mac at AAA. "The affirmation of the senior debt ratings," said the report, "reflects the strong explicit and implicit US government support these securities hold in the marketplace, as evidenced by recent US Treasury actions. This underscores the key public policy role and the key liquidity role the congressionally chartered government-sponsored enterprises (GSEs) have in the US mortgage market."

There is no question that the externalities of Fannie Mae and Freddie Mac's operating environment are challenging. House prices are falling, which will exacerbate loss severities, and unemployment is rising, which will drive default rates higher. Credit losses right now are higher than normal levels, and it is likely that they will get worse before they get better. Fannie Mae and Freddie Mac are not immune to the troubles that are plaguing virtually every financial institution. Nevertheless, there are three reasons why we believe Fannie Mae and Freddie Mac will survive through this market. First, the strong income fundamentals of the companies will be powerful offsets to their loss-provisioning efforts. Second, their regulatory capital should be able to withstand even the most aggressive loss scenarios, as the losses under these scenarios occur over time, not all at once. Time makes it possible for income, portfolio management and capital-raising to ameliorate the losses. And third, the US government has made it clearer than ever that Fannie Mae and Freddie Mac have a backstop if they need it, in the form of the Treasury debt and capital lines and the Federal Reserve's liquidity facilities. This should enable them to continue to easily fund themselves, mark-to-market and loss provisions notwithstanding, and should provide strong market confidence to investors in their senior unsecured debt obligations, like their discount notes, debentures and mortgage-backed securities.

Recently, Agency mortgage-backed securities have underperformed Treasuries. As the fixed income market realizes it has over-reacted to headlines, investors should be attracted to the relatively attractive yields on what are essentially government-backed securities (currently approximately 200 basis points over Treasuries).

August 12, 2008

*Jeremy Diamond
Managing Director*

*Robert Calhoun
Vice President*

Summary financial and operating statistics for Freddie Mac (FRE) and Fannie Mae (FNM) follow:



FRE	2Q 2008	1Q 2008	2007	2006	2005
<u>Income Statement</u>					
GAAP Income	(\$821)	(\$151)	(\$3,094)	\$2,327	\$2,172
Non-GAAP Adjusted Operating Income	(\$333)	(\$251)	\$2,067	\$3,853	\$3,175
<u>Operating Data</u>					
G-fee income	\$757	\$789	\$2,635	\$2,393	\$2,076
Effective G-fee (bps)	16.8	17.9	16.4	17.0	16.3
Net Interest Income	\$1,529	\$798	\$3,099	\$3,412	\$4,627
Administrative expenses	(\$404)	(\$397)	(\$1,674)	(\$1,641)	(\$1,535)
<u>Balance Sheet</u>					
GAAP Book Value	\$12,948	\$16,024	\$26,724	\$26,914	\$27,191
Fair Value Book Value	(\$5,600)	(\$5,200)	\$12,600	\$31,800	\$30,900
Retained Portfolio	\$791,798	\$712,462	\$720,813	\$703,959	\$710,346
Credit Guarantee Portfolio	\$1,823,803	\$1,784,077	\$1,738,833	\$1,477,023	\$1,335,524
Regulatory Core Capital	\$37,128	\$38,320	\$37,867	\$35,365	\$36,000
Minimum Capital Surplus	\$8,418	\$11,383	\$11,394	\$9,758	\$11,000
OFHEO Minimum Capital Surplus	\$2,677	\$5,996	\$3,452	\$2,076	\$3,451
Reserve (\$)	\$5,813	\$3,872	\$2,822	\$619	\$548
Reserve (bps)	30	21	16	4	4
<u>Credit Performance</u>					
Provision for Credit Losses	(\$2,537)	(\$1,240)	(\$2,854)	(\$296)	(\$307)
Charge-offs, net	(\$545)	(\$320)	(\$293)	(\$147)	(\$109)
Foreclosed Property Expense	(\$265)	(\$208)	(\$206)	(\$60)	(\$40)
Credit Losses (\$)*	(\$810)	(\$528)	(\$499)	(\$207)	(\$149)
Credit Losses (bps)	(17.3)	(12.0)	(3.0)	(1.4)	(1.1)
Credit-related Expenses (\$)**	(\$2,802)	(\$1,448)	(\$3,060)	(\$356)	(\$347)
Credit-related Expenses (bps)	(62.1)	(32.9)	(19.0)	(2.5)	(2.7)
Total Delinquent Loans (90+, foreclosures)*	1.04%	0.88%	0.76%	0.54%	0.71%
REO Balance	\$2,580	\$2,214	\$1,736	\$743	\$629
<u>Portfolio Characteristics</u>					
Weighted Average LTV (original)	71%	71%	71%	70%	70%
Weighted Average LTV (estimated)	67%	67%	63%	57%	56%
Weighted Average Credit Score	724	723	723	725	725

*Credit Losses are equal to foreclosed property expenses plus net charge-offs.

**Credit-related expenses consist of the provision for credit losses and foreclosed property expense



FNM	2Q 2008	1Q 2008	2007	2006	2005
<u>Income Statement</u>					
GAAP Income	(\$2,300)	(\$2,186)	(\$2,050)	\$4,059	\$6,347
<u>Operating Data</u>					
G-fee income	\$1,608	\$1,752	\$5,071	\$4,250	\$4,006
Effective G-fee (bps)	28.4	31.8	25.6	24.9	26.3
Net Interest Income	\$2,057	\$1,690	\$4,581	\$6,752	\$1,150
Administrative expenses	(\$512)	(\$512)	(\$2,669)	(\$3,076)	(\$2,115)
<u>Balance Sheet</u>					
GAAP Book Value	\$41,226	\$38,836	\$44,011	\$41,506	\$39,302
Fair Value Book Value	\$12,452	\$12,210	\$35,799	\$43,699	\$42,199
Retained Portfolio	\$754,116	\$726,705	\$727,903	\$728,932	\$737,889
Credit Guarantee Portfolio	\$2,284,094	\$2,241,775	\$2,160,497	\$1,797,297	\$1,618,070
Regulatory Core Capital	\$46,964	\$42,676	\$45,373	\$41,950	\$39,433
Minimum Capital Surplus	\$14,334	\$11,341	\$13,446	\$12,591	\$11,200
OFHEO Minimum Capital Surplus	\$9,439	\$5,074	\$3,868	\$3,784	\$2,730
Reserve (\$)	\$8,926	\$5,195	\$3,391	\$859	\$724
Reserve (bps)	31	18	12	4	3
<u>Credit Performance</u>					
Provision for Credit Losses	(\$5,085)	(\$3,073)	(\$4,564)	(\$589)	(\$441)
Charge-offs, net	(\$945)	(\$630)	(\$2,032)	(\$454)	(\$462)
Foreclosed Property Expense	(\$264)	(\$170)	(\$448)	(\$194)	\$13
Credit Losses (\$)*	(\$1,209)	(\$880)	(\$1,339)	(\$517)	(\$238)
Credit Losses (bps)	(17.5)	(12.6)	(5.3)	(2.2)	(1.1)
Credit-related Expenses (\$)**	(\$5,349)	(\$3,243)	(\$5,012)	(\$783)	(\$428)
Credit-related Expenses (bps)	(94.5)	(58.9)	(25.3)	(4.6)	(2.8)
Serious Delinquency Rate	1.36%	1.15%	0.98%	0.65%	0.79%
REO Balance	\$5,893	\$4,590	\$3,483	\$2,048	\$1,693
<u>Portfolio Characteristics</u>					
Weighted Average LTV (original)	72%	72%	72%	70%	70%
Weighted Average LTV (estimated)	65%	62%	61%	55%	53%
Weighted Average Credit Score	722	721	721	721	721

*Credit Losses are equal to foreclosed property expenses plus net charge-offs, but may not foot because of SOP 03-3 adjustments.

**Credit-related expenses consist of the provision for credit losses and foreclosed property expense

◆◆◆

This commentary is neither an offer to sell, nor a solicitation of an offer to buy, any securities of Annaly Capital Management, Inc. (“Annaly”), FIDAC or any other company. All information contained herein is obtained by Annaly from sources believed by it to be accurate and reliable. However, such information is presented “as is,” without warranty of any kind, and Annaly, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use. While Annaly has attempted to make the information current at the time of its posting on the site, it may well be or become outdated, stale or otherwise subject to a variety of legal qualifications by the time you actually read it. ©2008 by Annaly Capital Management, Inc./FIDAC. All rights reserved. No part of this commentary may be reproduced in any form and/or any medium, without express written permission.