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Annaly Mortgage Management, Inc.

Note on OFHEO's Special Examination of Fannie Mae

This week, the Office of Federal Housing Enterprise Oversight (OFHEO), which is the federal regulator of Fannie Mae and Freddie Mac, released its 340 page Report of the Special Examination of Fannie Mae. While the report went into considerable detail, there were no new allegations as it related to the accounting transgressions and the lapses in management and corporate governance that enabled them to occur. (You can read the entire report on the OFHEO website at <http://www.ofheo.gov/media/pdf/FNMSPECIALEXAM.PDF>.)

In conjunction with the report release, Fannie agreed to implement corrective measures and pay a penalty of \$400 million as part of settlements with OFHEO and the SEC. The other key elements of the settlement include a directive that Fannie Mae undertake comprehensive corporate governance and organizational control reforms, review current and separated employees for possible remedial action, continue to maintain 30% in excess capital and limit growth of its portfolio mortgage assets to the level of December 31, 2005. Fannie Mae must seek OFHEO approval in order to modify or lift the portfolio limit. Fannie Mae's mortgage portfolio stood at \$727 billion at December 31, 2005. For comparison purposes, Fannie Mae's mortgage portfolio at March 31, 2006 stood at \$721 billion, and at December 2004 stood at \$904 billion. We listened in to the Fannie Mae conference call discussing the settlement, and it is clear that the company is cooperating fully with OFHEO and the SEC, and is eager to move forward from here.

We don't believe that this settlement will have an impact on the Agency MBS market. (Fannie Mae's stock, however, was up on the day the news hit the tape as the stock market interpreted the settlement to mean that the worst is now behind the Agency.) As the market thoroughly absorbed the \$183 billion shrinkage of its mortgage portfolio since December 2004, we believe that holding Fannie Mae's mortgage portfolio at the level of December 31, 2005 should also not have any material effect. From a capital standpoint, the portfolio limit combined with the 30% capital surcharge help to make an already strong credit even stronger. Importantly, the settlement does not restrict in any way Fannie Mae's ability to create and guarantee new Agency MBS to sell in the secondary market. Last, the report may start moving the discussion in Washington for proposed GSE regulatory changes, but is unlikely to lead to any resolution. Both the House and the Senate had forwarded different bills proposing changes to the regulatory framework for Fannie Mae and Freddie Mac. Most observers have come to the conclusion that the differences between the two bills and the current political environment in Washington make it unlikely that any law will be passed. In any event, the Fannie Mae settlement accomplishes some of the same goals as the proposed legislation.

As we said in our "Note on SEC Statement on Fannie Mae Accounting" (December 15, 2004), we make no apologies for Fannie Mae or its executives. It turns out that the very worst accusations thrown at Fannie Mae—that senior management knowingly manipulated or disregarded accounting rules to ensure themselves of higher compensation—were true. To us, this is reprehensible from a business and a moral standpoint. Nevertheless, even with these transgressions, and with those that surfaced at Freddie Mac a year before, we continue to believe that Agency MBS are the premier asset-backed security in the world. Besides the Fannie Mae and Freddie Mac guarantee of timely payment of principal and interest (backed by a combined capital

base of over \$70 billion), the MBS holder is secured by the actual loan-to-value rating of the home, mortgage insurance, the income verification and maintenance of the homeowner, property/casualty and life insurance, the rights of foreclosure and the settlement process, and the reduction in principal amount from monthly amortization.

The last word on this issue is the market's: Confident in these multiple levels of security, the market understands that the underlying credit of the Agencies has not been materially affected by the events of the last three years. Mortgage-backed securities guaranteed by them have not been repriced because of these headlines. And the senior unsecured long-term debt rating of Fannie Mae and Freddie Mac is still triple-A.

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