



Michael Farrell, Chairman of Annaly, delivered opening remarks to the company's 2008 second quarter earnings call. We reprint those remarks below:

Rebirth of the Resolution Trust Corporation

The number one question asked of us over the past 15 years has always been, "What happens if Fannie Mae and Freddie Mac fail?" This question, of course, has always had a theoretical answer, but on Sunday July 13, 2008, when Secretary Paulson re-iterated the Department of Treasury's support for the GSEs, it got a lot more empirical. And on the same day, the Federal Reserve authorized the New York Fed to lend directly to Fannie Mae and Freddie Mac, if necessary. Sweeping legislation soon followed, which was enacted into law on July 30th. These policy responses were logical from a bond investor's point of view; the reality, however, is that at least on that particular weekend, Fannie Mae and Freddie Mac were nowhere near failing.

We will probably never know what truly spurred the actions of the Treasury and the Federal Reserve that weekend. Perhaps the macroeconomic realities of falling property prices and their effects on virtually every institution and citizen finally registered with policy makers, investors, regulators and the Administration simultaneously. While there are certainly significant differences, it reminds me of the capitulation in 1989, when the Resolution Trust Corporation was born and charged with the task of resolving the problems left in the wake of the savings and loan crisis of the 1980s.

Unlike many of my missives over the past several years cautioning about the problems in the housing and mortgage market, its denial by people who should know better (remember the phrase "it's contained") and the future state of affairs, I want to take a moment to reflect on the present.

First, I want to commend the Federal Reserve. I know this is not popular these days, but I do feel as though the people who work there have worked hard behind the scenes and in the public light to understand, quantify and react to the roller coaster ride that has been the capital markets for the past year. I believe that the Chairman is applying creative solutions to the hand that he has been dealt. Mr. Bernanke has never, to my knowledge, lobbied for or passed an earmarked project designed to get him reelected. Rather, he is there to get the job done. As I have said in the past, listening to Congressional hearings is a lot like listening to restaurant patrons argue with the management over the number on the check long after the meal has been served and digested.

Secondly, let's talk about Treasury. Secretary Paulson, working for a lame duck administration in the middle of a dynamic situation, managed to create a consensus among all of the varied interest groups pointing and sniping at each other and brokered a solution on a trillion dollar problem. As far as I can tell, Mr. Paulson is not receiving a placement fee for his investment banking services on this one. The question remains, though, what is the problem? Because of this uncertainty, corporations, consumers and institutions cannot move forward.

The uncertainty is still tied to residential and commercial property prices. In my opinion, the free market is restraining credit and lending in ways that the Central Bank could never dream to do in a politically correct way. Imagine for a moment where the markets would be if the Federal Reserve moved lending rates higher by several hundred basis points or so. That is what the credit markets have done over the past year. It is the polar opposite of what the Federal Reserve's actions have been designed to do.

There is a lot of talk about inflation in the markets. We are on record in stating that we think what we are witnessing is exactly the opposite. The asset deflation taking place in the property, equity and debt markets far outweigh, in dollar terms, any inflationary effect that is going on in the commodities markets. The drop in residential housing prices has taken away roughly \$2.7 trillion in domestic housing values. The recent peak to trough drop in the US stock market has slashed an additional \$4 trillion from household wealth. Globally, the numbers are even greater. On the other hand, the cumulative gain in commodities, as measured by the increase in the CRB, has created only about \$300



billion in gains. In our judgment, the restraint of credit and the losses in equity valuations swamp any long term inflationary effect from the commodities market. Inflation in the 1970s was closely linked to the relationship between wages, which were much more contractually based to industrial America, and prices. It is still having an effect on America's industrial companies today, as evidenced by GM and Ford's cost base versus foreign competitors. This was the backdrop of our fourth quarter's earnings call, "Welcome to the Keynesian Nightmare."

This scenario leads us to the recent GSE reform bill hurried through the House and the Senate in the last two weeks and signed by President Bush yesterday. This is the second time in my career that the GSEs have been swept up in the rip tides of macroeconomic politics. Fannie Mae was technically insolvent in the early 1980s, but the lines of credit that were linked to the US Treasury cemented the financial standing for both companies. These lines, as modest as they appear against today's trillion dollar balance sheets, were a large influence in determining the nature of the relationship between the US and the GSE financial statements. It is important to understand that the lines have never been used. Ever. Not in the 1980s when the yield curve was severely tested, not in the 1990s during the RTC liquidations, not even in the early 21st century when they were restating five years of financial results. According to our research foreclosures and serious delinquencies in their portfolios would have to double from today's levels for them to even get close to touching the newly established lines for support.

As we have stated in the past, Annaly is most concerned about the GSEs in two important dimensions, both of which are being underlined in the markets today.

In no particular priority here are our focus points: We care about them as a servicer of the loans which secure our assets. This is a fundamental business priority for the GSEs. They have large, disciplined organizational structures dedicated to the underwriting, origination and servicing of their mortgage book of business. They audit the chain link fence of activities within the payment system and make sure that investors like us receive our monthly payments of principal and interest on a timely basis. As many investors in structured products have found, maintaining current information, actually getting your checks on time is a priceless commodity today. The fact that NLY receives them through the Federal Reserve banking system via FedWire makes that functionality worth even more.

On an equal standing in terms of priority, is the GSEs' role as insurance companies for our mortgage-backed securities. They have never missed one penny of payment, ever. Insurance companies can live forever as long as they have access to funding and equity. If nothing else is accomplished in terms of healing the residential sector in the US, the Housing and Economic Recovery Act of 2008 has seen to that.

Here is my vision of the future for the GSEs, both short-term and long-term. With the ongoing stress in the real estate sector claiming more and more banking entities, the GSEs, along with the FDIC, are positioned to be the new Resolution Trust Corporations. The real-estate-owned part of their portfolios will grow as foreclosures continue, and they will be liquidating properties across the nation. FNMA and FHLMC will service, repair and re-underwrite the residential sector, the FDIC will handle the commercial sector along with the banking deposit bases. The United States Treasury is the immediate backstop for all of these activities. The Federal Reserve will be providing financing and some oversight. The new regulator will be a powerful restraint against any desire to dilute underwriting and investment standards.

Over the short term, the dynamics involved in the GSE debt and insured products should generate strong Net Interest Margins for the GSEs, albeit against the backdrop of a much slower origination and refinancing business. These conditions, plus the amortization from monthly principal paydowns, have created a scenario where the mortgage market is shrinking. Yes, you heard that correctly; the overall pool of mortgage debt will relentlessly become smaller, but its composition increasingly will reflect Agency-based industry standards. Shrinking day by day, month by month, payment by payment. This should set the stage for increasingly tighter spreads for Agency securities relative to their benchmarks.

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Chairman, CEO and President of Annaly Capital Management, Inc.
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