# Federal Housing Finance Agency

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September 4, 2008

Mr. Richard Syron
Chairman and Chief Executive Officer
Federal Home Loan Mortgage Corporation
8200 Jones Branch Drive
McLean, Virginia 22102

Dear Mr. Syron:

Please find attached a draft of our mid-year letter for Freddie Mac. Please note that the composite rating is "Critical Concerns."

This draft is provided for your information and should be provided to your Board.

Please contact me if you have any questions.

Sincerely,

Christopher H. Dickerson
Acting Deputy Director
Division of Enterprise Regulation

cc: Jerry Weiss

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**Federal Housing Finance Agency**

**DRAFT MID YEAR LETTER**

September [ ] 2008

Mr. Richard Syron
Chairman and Chief Executive Officer
Federal Home Loan Mortgage Corporation
8200 Jones Branch Drive
McLean, Virginia 22102

Dear Mr. Syron:

The composite rating of the Federal Home Loan Mortgage Corporation ("Freddie Mac" or the "Enterprise") is "Critical Concerns." This rating reflects critical safety and soundness concerns with Freddie Mac. 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. Moreover, the amount and quality of the Enterprise's capital is of critical concern and remains the subject of an ongoing examination. 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 net losses experienced year-to-date June 2008 as well as forecasted future losses, likely will require recapitalization of the enterprise.

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related to the capacity of the present management team and Board of Directors to resolve current issues, use of outdated models to inform decisions, weak financial performance, and less than a fully effective internal control environment, including the internal audit function.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 determinations of other than temporary impairments ("OTTI") of private-label securities ("PLS") and the likely potential of not fully realizing deferred tax assets ("DTA") are possible. A significant lack of market confidence has eliminated the ability to raise capital 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, capital position, and an inability to fully rely on representations made by the Board of Directors and management to the agency, the Federal Housing Finance Agency

("FHFA") [1] has lost confidence in the Board of Directors and the executive management team. This is particularly true given the delay and lack of transparency demonstrated by executive management in addressing repeatedly communicated regulatory issues and criticisms. 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 Enterprise 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 numerous necessary corrective actions within an acceptable time frame. These unsafe or unsound practices 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. 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. The Enterprise is clearly vulnerable to substantial further deterioration in capital given the current conditions in the mortgage market. As described more fully below:

- The Enterprise's own public filings have indicated accelerated credit losses in the most recent quarter;
- Reflecting increasing credit losses and the unpredictability of future losses, the Enterprise has ceased providing public guidance on credit losses;
- FHFA's current examination of the reserve process could have an additional negative impact on capital calculations;
- If unable to rebut the OTTI guidelines, the Enterprise may incur significant write-downs;
- The significant increase in DTA over the past five quarters, combined with uncertain market conditions, has raised questions about the DTA's quality and recoverability and about the current core capital number;
- The Enterprise lacks sufficient reserves for exposures to mortgage insurers and financial guarantors;
- The Enterprise continues to rely on inadequate modeling that has forced the Enterprise to repeatedly revise its own forecasts; and
- The Enterprise continues to rely almost exclusively on short, term, discount note funding.

Given the seriousness of our concerns, this letter communicates our summary judgment of the operations of the Enterprise based on long-standing areas of concern and our most recent

[1] For purposes of this communication, the term "FHFA" will refer either to the Federal Housing Finance Agency or its predecessor, the Office of Federal Housing Enterprise Oversight ("OFHEO"), as appropriate.

observations from both the first and second quarters of this year and year-to-date. Key issues facing the Enterprise at this time include, but are not limited to:

- The strength, cohesiveness, and depth of the present executive management team to cope with the severity and level of significant issues as well as to fulfill their mission are a critical concern to FHFA.

- 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 2008 to raise significant levels of capital.

- Credit risk management, the conduct of the Chief Financial Officer, capital management, portfolio management, and the development of a well-controlled and SOX-compliant internal control environment are areas of serious concern to FHFA.

- 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 exposure to litigation.

- Deteriorating market confidence in Freddie Mac and the other GSEs, as well as worsening market liquidity for GSE bullet and callable debt increased pressure on Freddie Mac's discount note issuance program to a critical level. The Enterprise's practice of relying on 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.

- Asset quality is poor and continues to deteriorate. Single-family serious delinquencies, credit related losses, and real estate owned ("REO") levels have dramatically increased. The PLS portfolio has more than $30 billion in mark-to-market losses, and 3Q OTTI is likely to have a material adverse impact on earnings and capital.

- 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 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 and unsound condition to transact business.

- Executive management is aware that models are not performing well in the current environment and has not devoted the resources 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 that are not subject to disciplined model change controls. These adjustments include very material reduction of model-produced loss reserves. This combination of problems makes the Enterprise vulnerable to errors, misjudgments, and possible manipulation and is an unsafe and unsound practice.

- The Enterprise had a GAAP net loss of $3.1 billion in 2007 and has experienced GAAP net losses of nearly $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 are at grave risk. Correspondingly, FHFA-mandated capital surpluses are also at grave risk as losses continue to mount.

- The amount and quality of capital is declining, and there is a very limited potential to augment capital meaningfully from external sources. This could lead to non-compliance with regulatory requirements, particularly if deteriorating asset condition requires further write-downs or the Enterprise is unable to raise additional capital.

The Board of Directors and executive management of the Enterprise continue to demonstrate significant material weaknesses in their oversight and operation of the Enterprise. These weaknesses have repeatedly been brought to the attention of the Enterprise in periodic examinations and interim regulatory guidance and direction, including the 2003 Consent Order imposed by FHFA. The Director met with the Board on several occasions to discuss these issues. Many of these and other issues were discussed in the Director's monthly meetings with the Chairman and Chief Executive Officer Richard Syron. Although the 2007 Report of Examination identifies certain areas in which some progress has been made, very serious fundamental problems have remained and, in some cases, worsened. Among other things, we have identified situations where the Enterprise has failed to inform FHFA adequately of its actions or has failed to take actions specifically requested by FHFA. In some instances, conduct of executive management has amounted to unsafe and unsound practices that have caused the Enterprise to operate in an unsafe and unsound condition to transact business. Recent adverse changes in the overall economic environment have magnified the impact of the Enterprise's weaknesses to the point where they pose serious risks to its mission and continued operation. In particular, FHFA is concerned that Enterprise conduct has resulted in:

- A substantial dissipation of earnings and assets due to unsafe or unsound practices.

- The Enterprise being in an unsafe or unsound condition to transaction business.

- A combination of inappropriate accounting practices, including an unsafe and unsound reduction in loss reserves.

- The Enterprise facing an inability to meet its obligations in the normal course of its business.

- Unsafe and unsound practices that are likely to cause insolvency or substantial dissipation of assets or earnings or to weaken the condition of the Enterprise.

FHFA replaced its CAMELSO and Enterprise Risk Management evaluation ratings on January 1, 2008 with a combined ratings methodology of GSEER: Governance, Solvency, Earnings and Enterprise Risk (Credit, Market, and Operational).

**Governance**

For the reasons set forth below, 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. This rating reflects FHFA's determination that more than moderate weaknesses and unsafe or unsound practices or conditions exist. Issues of concern include:

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

The Board of Directors is in violation of Article II, paragraph 13 of the consent order dated December 9, 2003 ("Consent Order") between FHFA and the Freddie Mac Board of Directors. 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 when this would be done. Conduct that violates a consent order provides grounds for a cease-and-desist order and civil money penalties.

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 Enterprise's affairs, and to maintain an appropriate succession plan for senior executive officers. In May 2007, Freddie Mac 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 departure and the Board of Directors still has not filled this key position. The lack of a complete executive management team during this period of tumult in the housing finance sector has exposed the Enterprise to increased risk. The combined failure of the Board to fill this important position and to maintain a viable succession plan raises serious safety and soundness concerns.

Board's Failure to Address Identified Matters Requiring Attention

The preceding findings are also indicative of broader failures of oversight by the Board of Directors. For example, there are 46 currently outstanding Matters Requiring Attention ("MRAs") covering Internal Controls, Credit Risk Management, Compliance with FHFA's Mortgage Fraud Reporting Regulation; and Governance. The majority of these MRAs are currently past due.

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 Report of Examination noted a marked 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 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 occurred. Contract provisions precluded simultaneously increasing pricing commensurate with the increased risk. Also noted were concerns with MIS and the failure of the Enterprise to operate without a Chief Credit Officer. In 2006 FHFA informed the Enterprise of its conclusion that the expansion of the Subprime Private Label Securities Portfolio outpaced the attendant risk management structure, and that the weaknesses in the pattern of practice 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 issuance of FHFA's conclusion letter, the vast majority of the $193 billion Retained ABS portfolio would have runoff.

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

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 unsound practice or condition given the unavailability of willing lenders to provide secured financing in significant size. Management failed to ensure that the Enterprise could convert unencumbered agency MBS to cash through secured lines of credit or an active repo funding program.

For example, Freddie Mac's 90-day liquidity policy was designed to make sure that under extreme stress, i.e., no access to the discount note market, that Freddie Mac 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 Freddie Mac in significant size.

Liquidity deficiencies are discussed more fully below under "Market Risk".

General Auditor Friction with Chief Financial Officer

The episode that ensued from acrimony between the General Auditor and the Chief Financial Officer reflects poorly on executive management and is the source of significant supervisory concern. The facts revealed through Board counsel's investigation reflect a pattern of inappropriate actions by both of these executive officers. Although the Board of Directors

took appropriate action to investigate the underlying facts, the Board did not issue a formal reprimand to the CFO or take any meaningful disciplinary action to penalize the inappropriate conduct of which the Board of Directors became aware.

Capital Raising

The Board and management failed to raise capital despite the March 19, 2008 agreement with FHFA as they were reluctant to honor their commitment to raise "significant capital" - especially any common equity. Management pursued several months of discussions with FHFA 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 in 2008 has now placed it in a market of heightened debt, equity, and mortgage market uncertainty, raising grave doubts about its current ability to raise additional capital. Most recently, private investors have indicated a lack of interest in Freddie's stock without government backing. Freddie Mac was hoping the private equity issuance 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 and unsound condition to transact business.

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

Accounting

FHFA has significant continuing concerns regarding the Enterprise's application of generally accepted accounting principles ("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 their decline in value at an accelerated pace. As we have previously communicated to you, management has been aggressive in its accounting in some critical areas, particularly with respect to OTTI and the implementation of the fair value option.

FHFA is concerned about the large amount of losses deferred in accumulated other comprehensive income ("AOCI") as they represent potential losses that would be realized if all 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 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 FHFA 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 to partially 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 to partially 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 FHFA regarding both the financial soundness of the insurer and the potential reputation risk to Freddie Mac.

To address OTTI shortcomings and to further consistency between the Enterprises, FHFA has issued a supervisory letter on the assessment and recognition of OTTI, which establishes a baseline set of assumptions for OTTI assessment with respect to all investment securities and in particular subprime and Alt-A PLS. The implementation of this guidance could result in a significant increase in OTTI recognized by the Enterprise.

FHFA periodically issues examination guidance regarding the implementation of new accounting standards, most recently for the Fair Value Option ("FVO"). Freddie Mac has failed to implement the FVO guidance with respect to its Liquidity and Contingency ("L&C") portfolio. However, management has made a verbal commitment to begin moving the L&C portfolio to full fair value beginning no later than October 1, 2008. As mentioned above, for the second quarter, Freddie Mac recognized $214 million in impairments on $72 billion of securities in the L&C portfolio.

Additionally, Freddie Mac's DTA have increased from $4.3 billion in 1Q 2007 to approximately $18.4 billion in 2Q 2008. This increase in DTA, coupled with the uncertain market conditions, has heightened our concern appreciably about the quality and recoverability of this ($18.4 billion) tax benefit. As a result, the reliability of the current core capital number has been called into question.

The continuing failure of the Board of Directors and management has raised serious concerns about the continuing safety and soundness of the Enterprise, has resulted in unsafe and unsound practices and has caused the Enterprise to be operating in an unsafe and unsound condition to transact business.

**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. Losses compounded by large preferred dividends payments are not consistent with 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.

There are significant uncertainties in the Enterprise's financial condition that raise serious concerns that the Enterprise's capital may in fact not be adequate. The quality of the Enterprise's capital has clearly weakened, with:

- substantial declines in the price of the Enterprise's common and preferred stock;
- increasing reliance on preferred stock relative to common stock;
- aggressive application of certain accounting policies;
- increasing shortfall between GAAP reserves and total expected losses.
- loss reserves and counterparty exposures, especially mortgage guaranty insurers (MI's) exposure to existing and future business;
- substantial increases in AOCI, which is not reflected in the statutory definition of core capital that we must use for regulatory purposes. Large negative AOCI amounts reduce shareholders equity even though it is not counted as part of core capital; and
- growing tax deferred assets and questionable realization of those assets.

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 FHFA. This failure is an unsafe and 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 (if ever), 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 Freddie Mac, further eroding the core capital surplus as losses continue. Current and projected earnings capacity remains insufficient to grow the capital base through normal operations.
- Lack of market confidence in the Enterprises continues to place pressure on liquidity.
- Capital projections have been repeatedly revised downward, raising concerns over capital adequacy in 2009 under a severe stress scenario. Identification of further asset write-downs likely will exacerbate this problem.

Taken as a whole, the preceding factors have caused the Enterprise to be operating in an unsafe and unsound condition to transact business.

**Earnings**

Earnings are 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 5 years and were most recently driven by increased credit costs. FHFA has previously issued supervisory letters s identifying concerns related to 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 private label security impairments. Forecasts of future earnings have been revised downward, as projections of credit-related expenses continue to rise substantially. Notwithstanding the dominance of credit-related expenses in earnings forecasts, future earnings are also exposed to fair value losses from spread widening of private-label securities, and security impairments. Future earnings are threatened by a massive overhang of unrealized losses on available-for-sale securities that may convert into security impairments in a stress scenario. These results are likely to cause 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 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.

- 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 2Q 2008); future expected credit losses not yet reserved for and substantial remaining OTTI and MI exposure.

- The Enterprise's own base-case earnings forecast results in a thin capital cushion by year end 2009. The matter is further complicated by the fact that the forecasting process has one outstanding Matter Requiring Attention. Thus, capital in the base-case forecast could erode much faster than indicated in the projections. Further, the forecast of earnings in a FHFA-specified stress scenario indicates that Freddie Mac's ability to meet regulatory capital requirements in a stress scenario may be at risk as soon as year-end 2008.

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 and unsound condition to transact business.

**Enterprise Risk Management (Includes Credit Risk, Market Risk, Operational Risk)**

**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 1Q08. 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 repeated urgings by FHFA.
- The Enterprise operating without a Chief Credit Officer and with credit-related internal management information systems and risk management processes that are not commensurate with the condition of the portfolio. This failing was discussed on several occasions with the Chief Executive Officer and the Board and is an unsafe and unsound practice that has put the Enterprise in an unsafe and unsound condition to transact business.
- The absence of a corporate-wide Credit Committee.
- The absence of risk-based pricing in 2006 and 2007 has created a situation that 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 mortgage insurers 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.

The amount by which the lifetime expected losses related to credit exposures exceeds the GAAP credit loss reserves has increased markedly. In response to increasing questions and heightened credit risk, FHFA is nearing completion of an examination to review the supporting documentation and process used in the reserving methodology, focusing on critical areas such as high risk products; the setting of the loss confirmation period; establishment of appropriate risk "buckets" for the transition rate calculation; the basis of collateral values used in the calculations of loss severity; and comparability between the Enterprises.

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, real estate owned (REO), and credit losses have risen substantially during this quarter and year-over-year. Moreover, the loan loss reserve for 2Q 2008 has increased by more than five-fold since 2Q 2007 signifying the Enterprise's acknowledgement and continued expectation of rapidly deteriorating credit conditions. Current market conditions, including continued rapid declines in house prices, double-digit levels of 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 by to 14.5 bps. 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; 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 2Q 2007 to 0.93% (excluding structured transactions) in 2Q 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 2Q 2008 to 17,415 from 12,480 one year earlier. However, REO inventories continue to rise substantially as inflows exceed dispositions. At June 30, 2008 there were 22,029 properties in REO inventory, more than double inventory levels in 2Q 2007 at 10,260. An estimated 52,754 REO properties will be acquired in 2008 high REO acquisition states include California, Arizona, Michigan, Virginia, Florida and Nevada — areas with higher than national average inventories or regional economic challenges.

Negative expectations of future credit performance and losses and ultimately earning and capital levels are demonstrated by the rapidly rising loss reserve. In 2Q 2008 management recommended a single-family loss reserve of $5.8 billion, compared to $1.1 billion for 2Q 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. Even more disconcerting is a series of memos in July and August that included the Controller and Chief Credit Officer that justified lowering the model-based credit reserves that required a series of aggressive, insufficiently backed adjustments.

The acquisition profile in 2008 has improved somewhat as a result of credit tightening and pricing increases effective earlier this year. However, early performance of the 2008 vintage is tracking to 2007 and has not shown improvement.

The deterioration in overall credit are the result of unsafe and unsound practices that have stressed the existing credit governance structure and have caused the Enterprise to be in an unsafe and unsound condition to transact business. The implementation of an Enterprise credit committee and designation of a Chief Credit Officer responsible for the credit strategy and credit results would augment and strengthen the credit governance structure. The business unit has begun 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 actual versus planned performance. The failure to have such structure in place raises concerns about the Enterprise's ongoing safety and soundness and has caused the Enterprise to be operating in an unsafe and unsound condition to transact business.

Multifamily (MF) Credit Risk

Risk in the multifamily 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 bps over the next few years from 6% to 7.25%, which could lead to a drop in property values between 10 and 15%.

The percent 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 YTD credit loss total to approximately $0.4 million. Credit losses are expected to increase slightly from their historical lows. Delinquencies decreased to 3 bps, consisting of two 60-day delinquent loans totaling $20 million.

Centerline

The December 2007 Centerline $2.8 billion TEBS (tax exempt bond securitization) 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 getting the deal done over ensuring that proper risk management is in place and financial viability is established first. This transaction was an unsafe and 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 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.

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

Enterprise Counterparties

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 Enterprise relies for credit enhancements, repurchases of substandard loans, portfolio servicing, loan modifications, derivatives, and other contractual safeguards creates an unsafe and unsound condition to transact business.

The rating agencies have downgraded most mortgage insurers ("MIs") and many of the financial guarantors that are Enterprise counterparties. 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 runoff 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. The Enterprise is concerned the MIs may not have sufficient capital and reserves to meet their commitments of first loss coverage. The eroding financial condition of the MIs may also negatively impact 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 LTVs greater than 80%.

Also, 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 remains evident.

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

Finally, the Enterprise had to increase its derivatives counterparty limits due to concentrations in 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, there are a limited number of suitable counterparties. To the extent that this results in excessive transactions with the remaining available counterparties these transactions may constitute in the aggregate an unsafe and unsound practice that would result in the Enterprise being in an unsafe and unsound transaction to transact business.

**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."

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 available-for-sale yet Freddie Mac recognized only $826 million non-agency securities impairment for Q2. Freddie Mac 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. Additionally, FHFA has issued a supervisory letter on OTTI that provides presumptive indicators of impairment. The use of these indicators could lead to significant increases in impairments as could the significant deterioration of PLS prices since June 30th.

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

And finally, with the lifting of the retained portfolio cap in March 2008, Freddie Mac grew its Retained Portfolio by approximately $73 billion during 2Q 2008. Second quarter growth

provided above-average projected returns driven by attractive option adjusted spreads assuming credit assumptions do not deteriorate. However capital constraints and illiquidity in long term debt markets will likely limit future growth.

**Liquidity-related Safety and Soundness Conditions**

Deteriorating market confidence in Freddie Mac, and the other GSEs, as well as worsening market liquidity for GSE bullet and callable debt increased pressure on Freddie Mac's discount note issuance program to a critical level. Freddie Mac'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 a 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 a monthly Benchmark Note issuance that also results in headline risk and a further erosion of investor confidence in GSE debt. This further lack of confidence could trigger significant sales of GSE debt, push down prices on GSE debt and effectively cut-off Freddie Mac'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 ("IRR") management as callable issuance is a key component to the IRR management practices of Freddie Mac, specifically the repurchase of options to offset the mortgage portfolio's short option position.

And finally, mortgage market conditions are so weak that significant MBS sales from the Freddie Mac 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 bps 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 capital position.

**Liquidity-related Safety and Soundness Practices**

Freddie Mac's liquidity management practices are critically inadequate and unsafe and 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 repo funding program or outright sales of MBS; designate the liquidity & contingency portfolio as held-for-trading; and ensure adequate cash management reporting.

- For example, Freddie Mac's 90-day liquidity report was designed to make sure that under extreme stress, i.e., no access to the discount note market that Freddie Mac would be able to borrow from the market using its agency collateral to raise more than $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 Freddie Mac in that size.

- On January 1, 2008, Freddie Mac decided not to include its Liquidity & Contingency assets in a held-for-trading account against the express requests of FHFA. During July 2008, Freddie Mac resisted selling long-term Liquidity & Contingency assets because of the potential embedded losses until FHFA forced Freddie Mac to take OTTI on that portfolio.

- During Q2, 2008, Freddie Mac's cash management report did not include $8.8B of possible contractual cash outflows associated with liquidity facilities provided by the multi-family business area. FHFA cash management exam identified this potential cash outflow and Freddie Mac amended its cash management report to include this significant liquidity contingency.

A mitigating factor is that management is complying 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, Freddie Mac relies on its ability to use the TBA mortgage market to fund prior commitments to purchase MBS by rolling its commitment to purchase MBS to future months. Currently, that practice relieves liquidity pressure by reducing anticipated cash outflows, however if the TBA mortgage market becomes stressed, Freddie Mac's economic cost to roll those significant MBS positions will increase. Today, Freddie Mac rolls between $50-$60 billion of TBA mortgages. The downside risk is that Freddie Mac could be forced to close out these commitments to purchase at a loss.

Interest Rate Risk

Extreme market volatility, ongoing model updates and estimated risk positions close to management limits raised significant supervisory concerns in Q2. During the quarter, management risk limits, including PMVS-L, Vega and peak convexity were breached on several occasions. Although the 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, Freddie Mac's prepayment models continue to overstate prepayments for conventional fixed rate products relative to actual prepayments. Although Freddie Mac'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. Freddie Mac 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 statistics, though we believe the PLS on-top adjustment was reasonable and well documented.

Freddie Mac 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.

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, in 3Q 2006 Risk Assessment Letter, FHFA 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 Enterprise will be operating for the foreseeable future. Management is aware that models are not performing well in the current environment and has not sufficiently devoted the resources to address this problem. Given that key models have been functioning outside acceptable tolerances and are producing flawed outputs, executive management has relied on manual processes and extensive changes that are not subject to disciplined model change controls or may not be implemented in a timely manner due to resource limitations. This combination of problems makes the Enterprise vulnerable to errors, misjudgments, and possible manipulation and is an unsafe and unsound practice.

(a) The market has moved beyond models at Enterprises. For example, prepayment models' projections do not match current experience requiring substantial management judgments. This model uncertainty results in greater risk in interest rate risk hedging.

(b) Model change control – Resources to adequately document model changes 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 Freddie Mac policy. Alternatively, model changes that correct poorly functioning models are delayed. An example is replacement of the SF LLR system that has been delayed three quarters so far. This issue has been raised in meetings with Model Oversight and with the business unit. Most recently, Freddie Mac'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 EUCs 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. It has been delayed by nine months, to the end of this quarter, so far.

(c) Model Inventory and Flow Charts – When Model Risk began examining Freddie Mac, 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 "found" (e.g., SF Costing) and added. Further, there is still no description of model interaction for the vast majority of models.

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

(e) 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.

(f) Outdated Credit Risk Models – Until last month, Freddie's key G-fee pricing and valuation model, Defcap, was 3 years out of date. FRE 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.

(g) Changing Risk Metrics - The historically used PMVS measure was discontinued in 1Q 2008 due to a sharp erosion of the fair value of equity. Between 2007 and 2008 the Board, based on the recommendation by management, decided to increase interest risk exposures at a time when credit costs were escalating. Interest rate metrics are subject to high degree of model risk in this environment. The Enterprise needs to maintain close attention to prepayment model exposure.

(h) 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.

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

(j) 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 and unsound practices that result in the Enterprise being in an unsafe and unsound condition to transact business.

**Operational Risk Management**

Operational risk is rated "Significant Concerns." This component evaluates accounting, financial reporting, information technology, internal controls, and operational models. This 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 some time. For example, in the 2006 ROE, FHFA stated that continuing weaknesses existed in information technology systems development and deliver, information security, end-user computing systems, data quality, and change management.

Information Technology

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. As the Enterprise evolves to a more automated environment management, it must balance the sequencing of business process changes needed to leverage systems and automation improvements. The success of the "alternative platform" is critical to the success of Freddie Mac in this area because the approach used (a modified service oriented architecture) will serve as the model for reusing legacy software in a way that provides flexibility and reliability without having to replace entire systems all at once.

In early 2008, Freddie Mac 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. The two information security significant deficiencies are scheduled for remediation in 3Q 2008. Remediation status is subject to Finance Internal Control Office and independent verification.

The establishment of an out-of-region area warm site for disaster recovery purposes continues. Management has signed a contract with EDS to provide warm site recovery capability in Auburn, Michigan. This location will provide four hour recovery for Tier 0 business processes and applications. This effort is nearly complete and on course for September 2008 implementation, but risks remains high until the implementation of the warm site is complete and effectiveness has been tested. To mitigate this risk until the Michigan facility is fully operational, management is using the Dallas data center for cut over-capability of Tier 0 applications.

Data Quality

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, but successful implementation of key plan milestones over the next several months will provide a better indication of implementation success.

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.

Internal Controls

Internal controls are not considered fully effective. Despite years of 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 shows that project management and senior management direction have not been effective. Recent PwC design reviews 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, especially related to the E2E project. Numerous internal project deadlines have been over-run since 2004, with very few repercussions for management and staff.

Operational Risk Management Oversight (ORO)

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 an unsafe and unsound practice that results in the Enterprise being in an unsafe and unsound condition to transact business.

For the foregoing reasons, the composite rating of the Federal Home Loan Mortgage Corporation is "Critical Concerns."

Sincerely,

Christopher H. Dickerson
Acting Deputy Director
Division of Enterprise Regulation

cc: Jerry Weiss