FINAL TRANSCRIPT

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FRE - Q1 2007 Freddie Mac Financial Results Conference Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Freddie Mac first-quarter 2007 financial results conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. (OPERATOR INSTRUCTIONS). As a reminder, this conference is being recorded.

I would now like to turn the conference over to our host, Mr. Edward Golding. Please go ahead, sir.

Edward Golding - *Freddie Mac - IR*

Thank you and good morning. Welcome to Freddie Mac's investor presentation and conference call, where we are very pleased to resume quarterly reporting and present to you our financed results for the first quarter.

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Speaking today are Freddie Mac's Chairman and Chief Executive Officer, Dick Syron, and our Chief Financial Officer, Buddy Piszel. Also joining us for the Q&A portion are Freddie Mac's President and Chief Operating Officer, Gene McQuade, and Executive Vice President and Chief Business Officer, Patti Cook.

As we begin, let me make two important points. First, we have posted on our website a slide presentations and core tables, which include additional details on our first-quarter results. You may want to have these available as Buddy walks through the numbers.

Second, please note that today we may make certain forward-looking statements regarding our business results. These statements are based on a set of assumptions about our key business drivers and other factors. Changes in these factors could cause our actual results to vary materially from our expectations.

You'll find a discussion of these assumptions in our Annual Report to Stockholders dated March 23, 2007 and in the Information Statement Supplements dated today, both of which are posted on our Web site. And we strongly encourage you to review these.

One final note - we would like as many people as possible to be able to ask a question. Therefore, if you would please limit yourself to one question and a follow-up, I would be grateful. As time permits, we will come back for a second round.

Thanks, and now let me introduce our Chairman and CEO, Dick Syron.

Dick Syron - *Freddie Mac - Chairman and CEO*

Thank you and good morning to all of you. We're doing this at a slightly different time than we've usually done it. We're doing that because we hope it works better for you, but we're interested over time getting your feedback and knowing if that is the case.

The first quarter of '07 was a very challenging period in the U.S. housing and mortgage markets. Housing prices declined. Mortgage credit tightened. Credit spreads and OAS spreads widened. As you can see in our GAAP and fair value results, we were affected by these changes.

Yet despite these headwinds, Freddie Mac gained ground last quarter, and I think that's thanks to our high asset quality, low risk exposures and improving operations. Freddie Mac is much better positioned for long-term profitability than we were a year ago.

Moreover, we're taking very important steps to serve our mission that demonstrate tangible leadership, and I think that will also serve our business objectives. And of course, as Ed noted, we are extremely happy with the fact that today marks the first time of putting out quarterly reports in the last five years.

All these strengths point to Freddie Mac's durability as a franchise, despite volatility found in financial results under both GAAP and fair value.

Now, I think one important measure is a driver, and that is our first-quarter increase in customer volumes. Thus far, in 2007, we have seen our guarantee business grow at an annualized rate of about 16 percent. In significant part, this is taking advantage of the shift in mortgage originations back towards our traditional sweet spot in the long-term fixed-rate area.

This robust increase in our volumes has enabled us to regain some share from the private label market and to grow at twice the rate of the market as a whole. Importantly, we have achieved this growth while maintaining a more cautious view than most

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towards credit risk. This has helped our aggregate credit statistics such as delinquencies to stay lower than the market as a whole.

As you all know, the guarantee business is very competitive. We saw a share reduction in our large customer, but we have also seen some recent wins that have us going from a minority position to parity with other customers.

I think what is really going on here is more originators are deciding that it is to their advantage to be in a position where they can go in the GSE space to either one of us rather than being tied to one agency. And I think actually, over the longer run, that it is to both our advantage because it helps us deal better with diversification in our customer base. But I think that is a longer-term trend.

Going forward, we intend to compete and succeed not only by leveraging our traditional strengths in the conventional conforming market, but also by developing new capabilities to serve our customers and our mission.

And those things go together. You've already begun to see some of it this year by our demonstrating our leadership in responding to the pressing and very first visible problems in something everyone reads about every day now, the subprime market.

In February, we became the first major market participant to announce that we would no longer buy subprime mortgages that posed an unacceptable risk of excessive payment shock and possible foreclosure.

In April, we followed up by announcing that we will purchase up to $20 billion in fixed-rate and hybrid ARM products that are being developed to limit payment shock and provide lenders with more and safer choices to offer subprime borrowers. We expect to begin purchases under this program this summer.

The steps we are taking on subprime I think do a couple of things for us. They are clearly consistent with our public mission, our congressional charter, and we also think they can be done in a way that serves our shareholder and business objectives.

Partially as a result of the uncertainty in the subprime market and in the spread product overall, mortgage rates have increased relative to cost of debt more recently. This widening has improved the OAS on new purchases into our retained portfolio and has presented us with our first real buying opportunity probably in the last several years.

Now, while we're still operating under our voluntary portfolio limit, we have some headroom, which we thought about and essentially put away to grow the portfolio this year, thanks to our ROE discipline and willingness to allow the portfolio to actually decline amid tight spreads last year. We took the first steps to expanding in this direction in the first quarter by growing the retained at an annualized 6 percent rate. We believe this serves our mission by providing liquidity to the market at a trying time and also did so at an attractive rate of return.

Another big achievement is our return to quarterly reporting today. Everyone knows this is something we have been focused on for a long time and remain focused on. This puts us closer to being able to grow our portfolio as market and mission conditions warrant.

We are making measurable progress on our financial remediation programs, and in light of this we are setting two specific target dates today - first, to release our full 2007 audited results within 60 days of year end, which meets the market standard for being timely; second, we begin - we expect to begin the SEC registration process in the middle of next year.

These are the last two major building blocks needed so there will be no question that Freddie Mac stands on the same footing as any other public company. And I think that is a reasonable expectation. I know you look forward to that day, as we do, and we are pleased that today's milestone of quarterly reporting brings us closer.

With that, let me turn things over to Buddy for a minute.

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Buddy Piszel - *Freddie Mac - CFO*

Thanks, Dick, and good morning, everybody. I am going to take a few minutes to provide a high-level review of our first-quarter 2007 financial results and current business trends. We've posted a package of slides that I will refer to in my remarks, but first let me give you the headlines.

As Dick mentioned earlier, the big story in the first quarter was the continued weakening of credit and the associated widening of spreads. Mark-to-market effects tied to this trend negatively impacted both our GAAP and our fair value results.

On the revenue side, net interest income in our retained portfolio was down year-over-year, though stabilizing. Management and guaranteed fee income continued its good growth rate. Our interest-rate risk metrics remain very low. Credit risk metrics have begun to tick upwards. We improved our internal control environment in several important areas. We made significant progress on our preferred-for-common swap through the end of May. And lastly, as this call confirms, we're resuming quarterly financial reporting and now see the path to timely reporting and SEC registration by mid-'08.

With that, let's turn to the GAAP results shown on slide 2. As we reported this morning, in the first quarter of 2007, Freddie Mac recorded a net loss of $211 million, down from net income of $2 billion in the first quarter of 2006. Most of this decline resulted from a swing in our mark-to-market results from a gain of about $700 million a year ago to a loss of $1.5 billion in the first quarter.

Outside these items, our pretax income was down about $355 million from Q1 '06, mostly due to two factors - one, compression of our NIM, which appears to be stabilizing; and two, an increase in credit-related expenses.

So let's start with the NIM. Line one shows that we had a reduction in net interest income of $153 million compared to the first quarter of 2006. As we discussed in March, our net interest margin declined last year as a flattening of the yield curve and the refunding of a significant amount of our lower-yielding long-term debt reduced our GAAP margin.

Since this activity mostly occurred in the first quarter of 2006, we are still seeing the effect in the year-over-year comparison. While it is not shown here, I should note that relative to the fourth quarter of 2006, net interest income and NIM have stabilized due to portfolio growth and lower debt refundings.

Moving to the guarantee business, line 2, shows that management and guarantee fee income increased by $47 million to $460 million as improved customer volumes more than offset a modest decline in our all-in guarantee fee rates. Thus far in 2007, we have increased our GAAP credit guarantee customer volumes significantly, as shifting origination patterns back to fixed-rate mortgages and our standard bid for a wider array of mortgage products have all produced good growth.

In addition, in this credit environment we're seeing good buying opportunities in our bulk purchase channel. Here we get to individually underwrite each purchase, which allows us to prudently grow our business with strong emphasis on risk and return rather than targeting specific market share.

Turning to expenses, line 6 shows that administrative expense increased by $30 million to $403 million, as we have continued to make strides in fixing our internal controls and our financial reporting capabilities. This is money well spent from my standpoint as it facilitated our return to quarterly reporting today.

We are continuing to invest in Freddie's future by adding personnel in critical business areas like operations and finance so we can meet our reporting and SEC filing objectives. Given our current efforts in these areas, it is likely that our full-year 2007 administrative expenses will come in modestly above last year's level.

Now over the long term, we believe we should be able to reduce our total administrative expenses on an absolute basis. On one hand, we will benefit from a sunset of all of the financial remediation spend and all the new technology that we're deploying.

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On the other hand, we are committed to fund the expansion of our business and increase spending on customer-facing systems and other business projects with a strong strategic rationale. So this is work in process that we will have more visibility into as we get to the end of the year.

Overall, we think that there is leverage in our business model, and administrative expenses as a percentage of the total mortgage portfolio will decline. Year-over-year on this basis, we are essentially flat at 8.7 basis points.

Finally, line 7 shows that our credit-related expenses increased to $193 million in the quarter. In response to deteriorating mortgage credit in specific parts of the portfolio, we increased our reserves for credit losses by $179 million, net of charge-offs and other transfers.

This increase was partly driven by higher delinquency to foreclosure transition rates, as well as increased average UPB levels on interest-only and adjustable-rate loans originated in 2006. In addition, significantly lower levels of house price appreciation throughout the United States increased the level of risk on our mortgages for most products and origination cohorts.

At the end of the first quarter, our total reserves for credit loss stood at $545 million or roughly 3 basis points of the total mortgage portfolio.

I should note that another measure of total credit costs is charge-offs for those loans that you resolve in a quarter plus REO expenses. This metric will generally lag the overall current market condition, but our cost for the first quarter was $58 million, an annualized 1.5 basis points of our average total mortgage portfolio. To put this figure in historical context, that is up from the very low 1.2 basis points a year ago, but well below our historical average level of about 5 basis points.

Just a reminder - we do not hold subprime loans directly so there is no contribution in the numbers I just mentioned from subprime. Also, we continue to expect no losses from our subprime-backed AAA-rated ABS security exposure. That said, we do expect our credit-related metrics to worsen from their extremely low levels, but our overall strong credit position should enable us to weather the housing downturn better than the market as a whole.

Now let me turn you to the GAAP mark-to-market items on slide 3, since these were the drivers of most of the year-over-year change. As I indicated earlier, Freddie recorded a loss of $1.5 billion pretax on mark-to-market items in the first quarter. About half of this resulted from negative mark-to-market on our derivative portfolio.

As previously discussed, this is a lopsided view. Far from adding risk, the derivatives we use in conjunction with callable debt actually help us to keep our interest rate exposure at low levels. This is because the losses on the derivatives are economically offset by gains on our debt funding programs and retained portfolio securities. However, both of those are not reflected in the income statement.

Moving down to line 8, increased market concerns over mortgage credit risk produced mark-to-market losses of $547 million in the first quarter. This includes negative marks on three items - the delinquent loans we buy out of PCs, certain pool purchases that have a built-in loss at inception, and the GO mark for Freddie securities we repurchase.

While these credit-related mark-to-market items significantly impacted our GAAP income statement in the first quarter, we feel that they potentially overstate the credit impact in our underlying results. That is because a significant portion of these losses reflect market uncertainty in the pricing of mortgage credit at March 31, and accordingly, the implied losses are higher than we expect to ultimately incur.

Let me now turn to fair value results on slide 4. Fair value of net assets declined by about $300 million in the first quarter as losses associated with OAS widening and market credit spread deterioration more than offset improved contributions from our underlying investment and guarantee activities.

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As you can see on line 1, investment activities in our retained portfolio contributed an increase of about $400 million in fair value in the first quarter. That is up from a decline of $100 million a year ago. If you adjust these results for OAS reductions, year-over-year returns improved because of higher core spread income and better returns on asset liability management activities and other market conditions.

In our guarantee activities shown on line 3, the change in fair value was a negative $1.2 billion in the first quarter compared to a gain of $1.1 billion a year ago. The '06 quarter benefited by about $800 million in positive valuation increases in the GA.

The '07 story is really shown on line 5, which shows a $2 billion decline, primarily due to widening credit spreads. About half of that related to the GO. The other half relates to losses we recorded on our portfolio of delinquent loans purchased out of the securities due to lower market prices and an increased population of those mortgages.

As I mentioned in our GAAP results, our experience suggests that the future credit losses implied by these marks both on the GO and the purchase loans are higher than those we ultimately expect to incur.

I will close on our progress on capital management, financial reporting and internal controls. First, capital - following the release of our '06 results, we initiated our preferred-for-common swap under our $1 billion authorization. We began our activities in late March, and I am pleased to tell you that we bought back $750 million in common shares and issued $500 million in preferred stock through the end of May.

Having spoken directly with many of our investors in the past few months, I know how important progress is on this front. While we still have work to do, our recent actions make it clear that this is a high priority for our management team and that we'll take every opportunity we can to deliver shareholder value through capital management activities.

On controls, improving our controls and financial timeline can only help in this effort. So let me make a couple points. First, with today's release, in 75 days we achieved an improvement of one full week over our year-end '06 release. My goal is to get to 60 days for the third quarter, and at this rate we're right on target.

Second, having been here for a little over six months, I am increasingly comfortable with our monthly and our quarterly processes and am confident that we will be able to issue our full-year 2007 Annual Report within 60 days of year end, which is timely by any standards. This puts us in a good position to begin the SEC registration process in mid-2008.

Third, we are continuing to improve our transparency. As I noted, we have added some additional detail to our fair value discussion and have disclosed option premium information that many of you have asked us for. While this isn't the end of our efforts, we are getting better with each release.

Lastly, we have addressed two more of our control issues - the first addressed the material weakness on the adequacy of staffing. We did this by filling critical vacancies in the controls and financial reporting areas and also by improving our HR practices. Second, we resolved issues related to new products governance, where we redesigned the process and controls over the implementation of new products. Overall, we're making very good progress on the remaining issues, and I'm optimistic that we will have the bulk of our control issues behind us by the end of the year.

With that, let me turn it back to Dick.

Dick Syron - *Freddie Mac - Chairman and CEO*

Thanks, Buddy. Let me just make a couple of capstone comments, because I think we are anxious to get to your questions. As we both discussed, the first quarter was a tough period for our industry, and there is no denying we were affected by some of

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the challenges you heard about. But the reality is that accounting conventions exacerbate the appearance of some of those developments.

I think it is also important to think about where we are in the grand scheme of things, and that tough times show which companies are built to last over the long run. And we are very proud of our high asset quality, the way we have handled risk exposure and our improving operations. And we think we are well-positioned not only to weather this soft market, but actually to use this as a way to position ourselves to thrive over the long term.

In the first quarter, our guarantee portfolio, because we gave some room here, showed strong growth. We seized market opportunities in a way that served both our mission, which is our brand, and improved return to shareholders. With today's return to quarterly reporting, we have passed a very important milestone. We believe we are on the upswing operationally.

Finally, we are continuing a strong multiyear trend of returning prudently common shareholder capital.

All that in my mind adds up to make Freddie Mac a solid long-term investment in a sector that continues to project strong endurable growth, tied to demographics of at least 8 percent a year.

The last business I was in was a manufacturing business, and I can tell you any quarter that we thought we were having a top line of 8 percent rather than trying to manage 2 percent or a decline of 1 percent was one where we were euphoric about. So we strongly believe that if you want to participate in this market, Freddie Mac is an excellent way to do that.

Much more importantly, we now want to turn to your questions. Ed?

Edward Golding - *Freddie Mac - IR*

Operator, may we take the first question, please?

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). David Hochstim, Bear, Stearns.

David Hochstim - *Bear, Stearns - Analyst*

I wonder, is there any way for us to estimate what you think the ultimate credit loss - your expectation of where ultimate credit losses are relative to the changes you reflect in financials from market price changes? That would be one question. And kind of a follow-up in advance would be, should we think about the loss reserve trending up to the 5 basis point level from 3?

Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

Estimate of losses, internally, we want our own model to give us an estimate of future default costs. And we compare that number to the market and try and ascertain what portion of the market we think is consistent with that view and what portion of it is - we will call it an additional price for the uncertainty around those numbers.

Now, at this point, we're not prepared to disclose that difference. But I would say that of the total mark-to-market, a substantial portion we believe is in excess of what we expect our future expected default costs to be.

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At the same time, we do recognize that over the next several years, we would expect our credit losses to return to a number that is more consistent with our historical experience. It that helpful?

David Hochstim - *Bear, Stearns - Analyst*

Sort of. But I guess I was wondering if - so there's basically nothing in the financials that would allow us to estimate what you expect the actual loss to be relative -

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Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

No. I think as we continued to commit to greater transparency, one thing we can consider over time is if we can get at a spot where we can give you that additional information.

Buddy Piszel - *Freddie Mac - CFO*

David, we put in the historical reference, just to make it clear, that today's current provisioning is at a very - relatively low level. I think we do expect that we will be going up. The pace that it will be going up really depends on what happens with house price paths going forward, whether this stabilizes, gets worse and what happens in the overall economy. So I don't think we are predicting - I think there is some good information in the fair value mark that gives at least the market's view of long term, where this may be headed.

Operator

Paul Miller, FBR.

Paul Miller - *FBR - Analyst*

When you file with the SEC, are you planning to be Sox-compliant? And also, can you go through the steps it will take, once you have filed with the SEC, and what you need to do with OFHEO to be more aggressive on your capital management?

Buddy Piszel - *Freddie Mac - CFO*

I will take the first half of the question and then I will hand it over to Dick. But procedurally, when we file with the SEC, our intention would be to be Sarbanes-compliant by the end of 2008. That is really not a requirement under the SEC as a first-year registrant, but that would be our intended outcome. And then let me hand it over to Dick as far as what the implications are with OFHEO.

Dick Syron - *Freddie Mac - Chairman and CEO*

Let me just talk about where we are on this sort of long march. And we have come a long ways - still have a ways to go. Today, as we said, we returned to quarterly reporting, for the first time in five years. We said that we would file '07 within 60 days of the close of the year. That will put us in the same position as any other corporation. We have said our objective is to file with the SEC in the middle of next year, and that will require, obviously, that we have timely quarterlies at that point.

That is as far as I would go out, particularly because in all of the various discussions we have had with OFHEO and others over time, it has never been contemplated that we would think about how long is it going to take for the SEC to process and go

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through our whole - all of our reports, etc., to get to declaring us registered. Our goal line and the goal line that has always been contemplated in what we have talked about is to get to the point where we have timely quarterlies and we file with the SEC.

Operator

Bruce Harting, Lehman Brothers.

Bruce Harting - *Lehman Brothers - Analyst*

Can you comment a little on your margins stabilizing? What makes you feel that that is the case, given the compression we have had and the move in rates?

And then flipping over to the mark-to-market side, you made the comment that the - I think on the pay fixed, the rallying in the longer end of the curve in the first quarter caused the mark-down and the asymmetry, and given the sell-off in the long end here so far in the second quarter, are you in a position to make any comment so we get a little bit of a feeling for the GAAP headline numbers in the second quarter? Thanks.

Buddy Piszel - *Freddie Mac - CFO*

I will take the first part of that. We do feel pretty positive about - a lot of the pressure that we were under for NIM compression that occurred between '05 and '06, we've gotten some relief. In the '06 period, we refunded a lot and even through repurchasing or just runoff, a lot of very low-coupon debt that was put on in '01 and '03. And when we now look at where we are today and the projected runoff of that very low-cost debt over the next, quite frankly, 10 years, it runs off very evenly. So we're not expecting any big shocks from that side of it going into 2007.

Secondly, we have seen a slowdown in amortization of our cash flow hedges, the loss on our cash flow hedges, as they are just starting to run off a little bit more.

Third, we are growing the portfolio.

And fourth, as the yield curve starts to steepen a little bit for the new business that we're putting on, which is a lot more 30-year than adjustable-rate, we will get some early NIM expansion.

So if you add all that together, it says that we're having some positive lift, we would think, on the NIM. I don't have a full projection as to where that would be, but I do get a sense that some of the pressure we were under will be relieved.

In regards to the opportunities for the second quarter, I think the only thing I would comment - in the first quarter, you do see that we did have a $300 million mark for where OAS has moved that enabled the core spread income to be up. I don't think we are prepared yet to comment on what that implies to the second quarter of 2007.

Bruce Harting - *Lehman Brothers - Analyst*

And just as a follow-up question, did you say you might see some lift in margin from the - is that implying the subprime activity you're doing, perhaps, or just the OAS widening that all talked about?

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Buddy Piszel - *Freddie Mac - CFO*

The OAS widening, not subprime. It will take a while for the cumulative impact of that $20 billion commitment to actually have any movement on our overall NIM. But it is a positive contributor over time.

Operator

Howard Shapiro, Fox-Pitt, Kelton.

Howard Shapiro - *Fox-Pitt, Kelton - Analyst*

Just a follow-up question on the mark-to-market change in your guarantee business. I guess this would be for Patti. What is the benchmark you use in terms of marking to market those assets? We know in the investment business it's the change in OAS spreads. What kind of mark-to-market or what kind of benchmark are you using for this business?

Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

When we go to the Street to look for a mark-to-market, we give them a targeted credit quality, if you will. So look at our book of business as if it were of AA credit quality and look at the subordination levels that S&P would require, and then put spreads on it consistent with what you are observing in the marketplace. And that is the way we arrive at that independent mark-to-market.

Internally, at the same time, we're running our own models that estimate the present value of the future expected default cost. And the value in the exercise is our ability to compare those two numbers, if you will, and begin to ascertain some information about our own models and about the Street's view.

Howard Shapiro - *Fox-Pitt, Kelton - Analyst*

So if the Street's valuation were lower or yours were lower, which governs, so to speak?

Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

The Street. Our fair value balance sheet is based on the third-party marks from the Street.

Operator

George Sacco, JPMorgan.

George Sacco - *JPMorgan - Analyst*

Given the volatility that you are - touching on the guarantee asset accounting, given the volatility that puts in your earnings and in your capital, and also considering that Fannie has been able to take a different approach and do something more of a historical cost accounting as opposed to mark-to-market accounting for the guarantee assets, has there been any thought to looking into ways that you might be able to change your accounting approach to that, just as a way of, again, smoothing out the earnings stream, minimizing the impact on capital?

And just the second question is, do you have the mix of your portfolio that is Alt-A?

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Buddy Piszel - *Freddie Mac - CFO*

Let me respond to the volatility question, George, because we struggle also with the volatility that we get with our guarantee accounting. But we think there is some helpful information in the overall fair value GA/GO marks. That being said, we are working on an effort to come up with a better way to communicate the results of the guarantee business, because we know it is difficult to discern, and we should be coming forward with something towards the end of this year.

Dick Syron - *Freddie Mac - Chairman and CEO*

This is Dick Syron. I just want to throw in one additional observation which relates to your question. How these companies, or at least this one, got into trouble in the first place was by trying to do things to present earnings in a smoother pattern than maybe traditional accounting approaches would have done. We think any attempt to artificially smooth earnings is something that we absolutely cannot do and would be the death of either one of these companies over the longer run.

George Sacco - *JPMorgan - Analyst*

I wouldn't want you to do something artificially. But if you have two methods of doing something that are both allowed under GAAP and one presents less volatility than the other, given that your capital is derived from GAAP earnings, we can make all the adjustments we want to make, but at the end of the day your capital is still affected by that.

Dick Syron - *Freddie Mac - Chairman and CEO*

You're absolutely right. Look, we have taken the approach that we think is the most transparent - I'm not criticizing anyone else, but we think we have taken the approach that is the most transparent, the most independent in terms of using outside market approaches, among a number of other things. So maybe it is a little bit, given where aware coming from, we're being purer than thou. But it is something that we're very cautious about, but it doesn't negate your observation.

George Sacco - *JPMorgan - Analyst*

And then also, is the mix of your portfolio that is Alt-A-?

Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

The mix of our portfolio that is defined as Alt-A by our customers, because that is really the only way you get at that designation, we would estimate that maybe 5 percent or less of our portfolio that comes through flow is Alt-A, and on the bulk business it is about 2. So I am comfortable saying it is less than 10.

That measure for us is not the one, obviously, that guides the risk profile of the portfolio. We are more attentive to the actual risk characteristics of the loan than we are their characterization or categorization as Alt-A.

George Sacco - *JPMorgan - Analyst*

In terms of pricing for the guarantee business, guarantee fees, it would be driven on your own classifications, not how your customers necessarily classify it.

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Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

That is right. It is driven on the risk characteristics of the loan - LTV, FICO, low-doc, etc.

Operator

Fred Cannon, KBW.

Fred Cannon - *KBW - Analyst*

Just a question on interest-rate volatility. We have seen interest-rate volatility increase during much of the year. And I was wondering if there was any impact on mark-to-market or earnings in the first quarter from the increase in volatility. Given the moves that we have recently seen, can we expect some impacts moving forward?

Buddy Piszel - *Freddie Mac - CFO*

Well, clearly, in the first quarter as volatility continued to decline, we took big negative marks in our derivatives portfolio. That is the bulk of why that $765 million negative mark occurred. I think your observation is fair. Given where volatility is moving and where the long rates have moved in the second quarter, we may be getting some relief in the second quarter.

Operator

Thomas Mitchell, Miller Tabak.

Thomas Mitchell - *Miller Tabak - Analyst*

When we look at going forward, the next three or four quarters, do you expect to be able to add enough good new business so that we actually see, not necessarily in the second quarter but in the third or fourth quarter, we start to see the kind of net interest margins you had going back to, say, the second quarter of 2006?

Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

I'll take that question. If you look at the changing composition of the portfolio as we speak, and what do I mean by that - I think you can observe that fixed-rate mortgages today are enjoying less liquidity than they did a few quarters ago. Therefore, those spreads have widened and they provide both a mission opportunity and a profit opportunity for us in the portfolio.

As those securities increase as a percent of our overall portfolio, you will see a widening in our net interest margin. It is going to depend on the pace at which we are able to add those securities to the portfolio. But your observation is correct - the shifting profile of the securities in the retained portfolio, given current market conditions, will tend to have an upward bias on them.

Operator

James Fotheringham, Goldman Sachs.

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James Fotheringham - *Goldman Sachs - Analyst*

The GAAP losses continued to erode your reported core capital, which is, for better or worse, the regulators' preferred method of assessing capital adequacy. How do you see this impacting your discussions with OFHEO regarding the potential return of excess capital to shareholders subsequent to your return to timely reporting this year?

Buddy Piszel - *Freddie Mac - CFO*

Well, as we made clear on this call, when we talk to the regulator of our results, we also point out very clearly that that part of the result that is related to really uneconomic derivative marks that are fully hedged, and they are very familiar with our risk management practices, is really not as negative as it appears.

That being said, when you have three quarters in a row when you have negative derivative marks, it would be nice to get a quarter where they reversed. And we may be coming towards a period in market conditions where we'll get some positives.

So I think they fully understand the implications of what is driving these losses. It certainly would help to have gains, but I think we have a good discussion with them on that dimension.

Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

And I think at the same time, we don't currently feel constrained in terms of the activities we want to engage in in the retained portfolio because of that observation.

Operator

David Hochstim, Bear, Stearns.

David Hochstim - *Bear, Stearns - Analyst*

I wonder, Patti, if you could just talk some more about the changing market conditions over the last couple of months and kind of explain the improvement in OAS and if this is a maybe more permanent change. Which buyers are stepping out of the market and how significant is it that we're seeing some increase in fixed-rate originations?

Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

It is really interesting, David, to go back and look at the discussion in the marketplace of a year ago, where there was plenty of speculation as to whether or not you needed the GSEs because of all the aggressive buying that was occurring in mortgages, particularly on the part of banks and the infamous Asian investor.

And I think what you're seeing now is a pullback from those two constituents for a whole variety of reasons at a time when fixed-rate origination is actually increasing. So I think if you look at that dynamic, the result is wider option-adjusted spreads, and as a result, a greater opportunity and really requirement for us to provide some liquidity to the marketplace.

I think it is really hard to speculate whether this change in environment is going to persist for months, quarters, years. What I would say is that we are attentive to both the opportunity and the need for us to engage now.

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David Hochstim - *Bear, Stearns - Analyst*

And maybe following up on that, if you find too many purchase opportunities, then you are constrained by the growth limit. Would achieving Buddy's goal of 60 days to report third quarter mean that you're current at that point, or do have to report the year? At what point does the OFHEO limit come off?

Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

Before Buddy talks about the limit coming off, I just want to make sure that you can appreciate the flexibility we have where we are now.

David Hochstim - *Bear, Stearns - Analyst*

Absolutely. But let's just say you have the phenomenon, like a -

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Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

Yes, I hear you. You get constrained by the cap.

Buddy Piszel - *Freddie Mac - CFO*

David, the formal agreement we have with OFHEO requires the return to quarterly reporting and doesn't specifically have any reference to timely. That being said, we know that the regulator will weigh in here, and we are beginning discussions with them.

Dick Syron - *Freddie Mac - Chairman and CEO*

Look, not to beat this to death, but I think all of this has to be taken, which is why Patti's admonition about forecasting is correct, in the context of the time. Our responsibility, our mission, is to provide liquidity, stability and affordability.

Now, if you were to start to see spreads widening very much because of some of the things that Patti talked about, some of those things even exacerbating, that would really call into question I think whether the GSEs should be engaged in this market more actively as a result of the reason that Congress set them up in the first place.

Operator

[Kirk Caller], Charter Bank.

Kirk Caller - *Charter Bank - Analyst*

I wanted to ask about the ramifications of implementing Financial Accounting Statement 159, given the earlier comment about the mismatch between the mark-to-market on the derivatives and not marking the callable debt to market, and what you see are the ramifications, and can you discuss your plans for implementing 159?

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Buddy Piszel - *Freddie Mac - CFO*

For everybody else, 159 is the option to adopt fair value for certain aspects of your assets and liabilities. And I think part of it was intended to be able to get companies to, in effect, achieve the outcomes from hedge accounting without having to deploy a more rigorous standard.

We are taking a hard look at that, but I will tell you I don't think there is a silver bullet there. While you do get - if you did a full mark-to-market, you do get an offset for certain of the items that we hedge, but certainly the items we don't hedge, and you can see that in the volatility of our fair value results.

So we don't hedge OAS risk. We don't hedge mortgage-to-LIBOR risk. And those are aspects of - they are different volatility, so they don't necessarily solve the problem. But we are looking into it to see if there are aspects of 159 that would help counter some of this volatility that we're seeing on our GAAP numbers.

Edward Golding - *Freddie Mac - IR*

Operator, can we have one more question, please?

Operator

Howard Shapiro, Fox-Pitt, Kelton.

Howard Shapiro - *Fox-Pitt, Kelton - Analyst*

Just one follow-up. You had mentioned earlier in your overview that your average guarantee fee rate had fallen. Can you just discuss - is that a mix issue? I would think in an environment where credit spreads are widening, it would have gone the other direction.

Buddy Piszel - *Freddie Mac - CFO*

This is Buddy. The decline in the all-in g-fee is really looking at the reported numbers in our financial statements, which had the impact of the acceleration or deceleration of amortization related to the way you recognize g-fees. So I don't think it is really the economic view of g-fees. And Patti, maybe you can comment on really where all-in g-fees with customers are at.

Patti Cook - *Freddie Mac - EVP and Chief Business Officer*

There's two things about the g-fee price setting that are important. First of all, they are longer-term contracts. So unlike looking at the capital markets for change in spreads, even if the capacity existed to change g-fees, you are going to see them on a lag basis because of the nature of those contracts.

I think secondarily, the bulk of that business that is reflected in g-fee is prime and is of very high credit quality, where I think you have seen much less market reaction and repricing in that end of the market as opposed to subprime.

So you've got two things affecting your all-in g-fee. One is the term nature of those contracts, and second reflecting that the bulk of that business is a very high credit quality and is priced for a full market cycle. It is not going to change that dramatically as we go through various house price paths.

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Dick Syron - *Freddie Mac - Chairman and CEO*

This is Dick Syron. I just wanted to thank all of you for calling in. We think again that this is a complex business, but obviously, your questions reflect an understanding of the complexity of the business.

And one last point - I think it is important every now and then that we step back and think of things over the intermediate term rather than, as I say, the exacerbation of some trends that can be caused by our accounting treatment. We want to make this as useful as possible for you, and any suggestions you have, Ed Golding would be very interested in hearing them.

Thank you again for your time.

Operator

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