

FINAL TRANSCRIPT

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FRE - Q1 2008 Freddie Mac Earnings Conference Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Freddie Mac first quarter 2008 conference call. At the time calls are in to listen only mode. Later we will conduct a question and answer session. (OPERATOR INSTRUCTIONS).

At this time I would like to turn the call over to Edward Golding, SVP of Investor Relations. Please go ahead.

Ed Golding - Freddie Mac - SVP, IR

Thank you and good morning. Welcome to our investor presentation and conference call, where we present to you our financial results for the first quarter of 2008. Speaking today are Freddie Mac's Chairman and CEO Dick Syron, our Chief Business Officer

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Patti Cook, and our CFO Buddy Pizel. Before we begin, let me make two important points. First we have posted our slide presentation, 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 upon a set adjustments, estimates, and assumptions about 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 factors in our 2007 Information Statement and Annual Report, and in today's Information Statement Supplement, both of which are posted on our website. We strongly encourage you to review these factors.

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

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

Richard Syron - *Freddie Mac - Chairman, CEO*

Thanks Ed. Good morning, and thanks to all of you for taking the time. During the first quarter, we continued to see a housing market in distress. Throughout this period, Freddie Mac worked in a counter-cyclical way to support the housing finance market, and to advance the recovery of the housing sector. The company reported a net loss of \$151 million for the first quarter, down significantly from our fourth quarter loss of about \$2.5 billion.

Our results reflected a balance of three factors. One, growing revenues based on increasing volumes. Two, changes in our accounting, that more closely aligns with the underlying performance of our business. And three, worsening credit conditions.

In our single-family business we have improved our underwriting standards by insisting on better credit quality for new guarantees and reducing our volumes of riskier loan products. By combining these efforts with the use of risk-based pricing, we assure continued credit access for America's homeowners.

In our growing multifamily business, we have continued to finance residential rental properties, despite the near shutdown of the CMBS market. By doing so, we have helped stabilize the market and made rental housing more affordable. This segment of our business is especially important to our mission at this point in the cycle.

In our retained portfolio, we continued to maintain a very low level of interest-rate risk, even through a volatile first quarter.

Our ability to provide stability, liquidity, and affordability during the market crisis was a major reason Congress and the Administration included our support for the conforming jumbo market as part of the economic stimulus package. We recently began to buy conforming jumbo loans in 224 high-cost markets. And this has already helped drive a significant drop in the rates on these loans to consumers. We have also been active in helping delinquent borrowers seeking to avoid foreclosure. And we are exploring constructive and creative ways to work out loan modifications for the distressed homeowners. Our purchase of MBS, through our retained portfolio, has helped lead to a marked reduction in spreads in that market. Continuing to support the recovery of the housing sector is crucial to U.S. homeowners in the broader economy, since it is clear we have not yet hit bottom in the housing market.

Now previously, we have said that we expect housing prices to fall at least 15% nationally, peak to trough, and today they fallen about 9% through the measure we use, which is relative to our market. We want to take a better look at the spring housing market to see whether or not the data is beginning to firm up. It is premature at this point from a data perspective, to make a change in our formal peak to trough estimate. However at this point, we must say that the risk to the forecasts are strongly weighted on the downside. Given the severity of the price declines in the first quarter, and the growing inventory of foreclosed

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homes, we have experienced an increase in charge-offs and REO expense associated with higher loan loss severities. As a result of this change, we raised our estimate for expected future default costs, and increased our provision.

Although credit will continue to be an overhang, significant advances in financial reporting, controls remediation, capital management and better returns on our growing new business volumes make me confident we can improve our bottom line results for 2008. A healthy and profitable Freddie Mac is essential for the stability of the U.S. housing system, and for the benefit of the entire U.S. economy.

During the first quarter, improvements in our financial reporting policies that better align realization of income and expenses, reduced our GAAP income statement sensitivity to changes in credit and interest rate markets. That helped our first quarter results. These new accounting policies will make our future financial results more comparable to other financial institutions and more reflective of our underlying business.

During the first quarter we also made significant strides in completing our work on controls. Within our release in 44 days, we managed to slice 16 days off our schedule from year-end, and we've also completed the remediation of all of our material weaknesses. The combined effect of our simplified financial reporting, stronger controls and improved returns on our new business, put us in a position to manage our capital more effectively. With capital levels of more than \$38 billion at the end of the first quarter - \$6 billion above our mandatory target, and \$11.5 billion above the statutory requirement, we do remain in a strong and sound capital position.

Having said that, in an effort to continue to support the housing market, and take advantage of the opportunities now available to our shareholders, Freddie Mac will raise \$5.5 billion in new capital consistent -with the agreement with OFHEO to reduce our surcharge to 15% on issue, and ultimately to reduce our capital surcharge to 10% this fall. This capital raise will be deployed in ways that we are convinced will benefit shareholders, as well as help us stabilize and support the housing market. And that fact feeds our confidence so that we can continue to improve our results for the year. Thank you for your time, and with that, I will turn things over to Buddy.

Buddy Pizel - *Freddie Mac - CFO*

Thanks Dick, and good morning everyone. Today's results are clearly driven by the housing market. But first let me pause, and mark a major turning point. With today's release, Freddie Mac has basically completed our major efforts to improve the timeliness, controls, and transparency of our financial reporting. This has three immediate benefits.

First, as a result of these changes, our accounting policies and earnings emergence now better reflect the performance in our underlying business, improving their clarity and comparability to those of other large cap financial institutions. Secondly, we have fully remediated all outstanding material control weaknesses, and finally, with this quarter's demonstration that we can achieve timely quarters, we'll be taking the ultimate step very shortly, and will become an SEC registrant. These actions close a long, and a very difficult chapter in Freddie's history, and one that will never be repeated. You have our commitment that we are on the way to being as well run a financial institution as any out there.

So we turn to the first quarter, our loss was \$151 million or \$0.66 per share, compared to a loss of \$2.5 billion or \$3.97 per share in our fourth quarter. Much of that improvement was due to changes in our operational and accounting practices, specifically related to mark-to-market items. Through the first quarter, our results do not yet reflect the anticipated positive effects of significant retained portfolio growth, or improved pricing in our guaranteed portfolio.

With that let, me take you through a high-level summary of the first quarter, and how we see 2008 shaping up. If you would please turn to slide one. For the first quarter, holding aside the mark-to-market items, NIM was essentially flat, and the g-fee revenue grew with portfolio balances, but credit costs also remained high. Compared to the fourth quarter, in the first quarter,

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guarantee revenues increased by \$91 million, or roughly 13%, mostly due to growth in our average PC balance, and a higher total guarantee fee rate.

Net interest income increased by \$24 million. Portfolio balances were essentially flat, but nonetheless, given the yield curve steepening, you would have expected greater NIM expansion.

Credit related expenses increased by \$536 million, as higher loan loss severities and serious delinquency rates produced greater provision and REO expenses. Finally we did not record any credit rating impairments on our portfolio of private label asset back securities.

Let me give you a little color on why the net interest margin was essentially flat for the quarter. During February and March the significant flight to quality in the front end of the yield curve - that is between the one- and three- month maturities - produced a mismatch in the reset rates of our floating rate assets compared to the turnover on our short-term debt portfolio. Very simply, since our assets reset on a monthly basis, that reset was down. Our short-term debt, which at year-end had about an 80-day average maturity, did not reset as quickly. The result was a reduction in NII of about \$210 million, contributing net spread compression of about 11 basis points. This impact was accentuated, since during the first quarter we took conservative funding measures, and actually lengthened our short-term maturities to approximately 90 days. While this compression was offset by margin expansion on the fixed-rate assets, the net result was a flat NIM. Absent the floating rate compression, we would have actually increased our NIM to about 60 basis points.

And the important point to note is that this should not be a recurring item and we expect with expansion throughout 2008 as retained portfolio purchases increase with wide initial gap margins. As we committed at our investor day, increased visibility into our results have given us greater comfort in providing additional guidance on revenue and credit results for full year 2008 versus 2007. Based on the current growth opportunities and credit environment, we would expect to achieve 15% to 20% revenue growth in contractual guarantee fees and delivery fees. We expect with expansion this to result from higher g-fees on new business and around 10% growth on our guaranteed portfolio. We'd also expect to achieve 40% to 50% revenue growth in net interest income. We expect this to come from significantly higher NIM on new purchases, and strong portfolio growth, much of which through today has already occurred. As we've indicated, on the credit side, we also expect to see an increase in our 2008 provision to approximately \$5 billion to \$6 billion.

Based on the strong revenue growth opportunities we're seeing, tied to the expanded role for the GSEs that Dick talked about, we decided to raise an additional amount of capital to fund future growth. While we expect to formally launch the transaction, in the very near term, I am comfortable enough with our status to give you some high level elements of our plan. Our plan is raise \$5.5 billion, split roughly 50/50 between a non-convertible preferred, structure and common. We do not currently anticipate further reductions in dividend payments. As we indicated on our investor day, we are proceeding thoughtfully in our capital raise process, and will initiate the offerings, once our SEC registration is complete, which again, should be very shortly. So that means from a registration standpoint we are ahead from where we expected to be.

If you now turn to slide two, this slide gives you a high level overview of our current capital position and how we would expect to look once we complete our issuance. Raising this amount of capital will provide three benefits. First it will provide for flexibility and strength that will help fund profitable growth opportunities in our business.

Second OFHEO has told us that upon completion of our planned capital offerings, the intent is to reduce our mandatory target capital surplus amount to 15%, from the current level of 20%. In addition, OFHEO has informed us that it intends to further reduce the surplus amount to 10%, based on the following - completion of the SEC process, completion of the remaining consent order requirement to separate the position of Chairman and CEO, and our commitment to continue to hold capital well above the regulatory requirement, and lastly, no material adverse change to our ongoing regulatory compliance. Finally, the capital will provide us with additional downside protection in the event of dramatic credit deterioration.

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Just as important to strong capital is the fact that given our reduced mark-to-market sensitivity, there is a greatly reduced risk, of fresh capital being used to fill a hole.

Let me now take you briefly through slide three that shows the improvements we've experienced in the first quarter and the reduced potential for adverse capital impacts, going forward. As you can see on line 11, during the first quarter, our results benefited from a reduction of \$3.6 billion in pre-tax mark-to-market losses. These were split roughly half and half, between interest-rate and credit-related items. On the interest rate side, as we previously discussed we've taken two steps to reduce our interest-rate sensitivity. First, line one, shows the combined impact of a shift in the composition of our derivatives portfolio and a steepening yield curve. Our mark-to-market losses fell by \$923 million in the first quarter. We did begin to benefit in the quarter from our hedge accounting efforts and continued expansion of hedge accounting will have a greater positive effect on our interest-rate sensitivities going forward.

Second, effective January 1, we adopted FAS 159, the fair value option, by identifying a basket of assets to mark to fair value through our income statement and effectively offset the valuation changes in the guarantee assets. Lines two and three illustrate the first quarter effect of this change, and as you can see, its working. On the credit side, we made one really big change in the first quarter - the elimination of losses on certain credit guarantees, our day one difference. In the first quarter and going forward, we have modified our processes, so that we'll now record the GO on new guarantees at a similar valuation of the GA on those assets. Given effect to this change resulted in a reduction of \$1.3 billion in losses compared to the fourth quarter of '07 as shown here on line six.

One more item I should point out is the losses on loans purchased out of securities shown on line seven. While we made the change in our operating policy of buying loans out of securities in December, this is the first full quarter of the new policy. Due to sharply lower loan purchase volumes, we recorded a loss of only \$51 million on this item, almost \$700 million less than in the fourth quarter.

Turning to slide four, as we discussed on investor day, we have set a goal for the company, of getting our overall interest-rate sensitivity down to about \$1 billion for a 100 basis point move, or about \$10 million per basis point. While we're not quite there, you can see that thanks in part to the implementation of the fair value option and hedge accounting, our sensitivity was down significantly, from that in the fourth quarter. Keep in mind that this level could be adversely impacted by spread risk, based on the assets and liabilities we now record at fair value.

Moving to slide five, one question we've received over the past several quarters is, how were the adverse mark-to-market items that we've previously taken reversed through earnings? As you can see at the end of the year, our retained earnings and capital included previously recorded pre-tax losses, attributed to losses on loans purchased and losses on certain credit guarantees, of about \$3.8 billion. While the changes we have made to our financial reporting will help safeguard our regulatory capital against future losses of this sort, the historical amounts will reverse over the next several years through the income statement line items shown.

During the first quarter reversal of these marks resulted in a reaccretion of \$536 million pre-tax. As a clarification, the reversal of the \$234 million shown here on line two, as losses on certain credit guarantees, is a component of the income on the guarantee obligation on our income statement and is about \$80 million higher than we would normally expect to recover in a single quarter. The reason for that is that during the first quarter this reaccretion was accelerated as a component of income on GO. Under our new GO accounting, we record stepped up amortization income when house prices decline significantly in a quarter. While this may seem counterintuitive, the policy allows us to better reflect earnings and margins through GO income with the recognition of higher incurred losses.

During the first quarter, total income on the GO increased to \$1.2 billion, from \$528 million in the fourth quarter. While the rate of recapture on the GO will vary from period to period, in general, we would expect it to be recovered within a few years as the loans underlying the securities we guarantee pay down. If you turn to slide six as Dick noted earlier, as a result of the more severe house price deterioration in the first quarter, increasing delinquencies, and higher severity rates, we experienced a

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significant increase in charge-offs and REO expense in the first quarter, moving to an annualized quarterly loss rate of 11.6 basis points, compared to 5.4 basis points in the fourth quarter. These same factors drove an increase in our expected charge-offs for 2008 and 2009, and raised our guidance for full-year 2008 provision.

On slide six you can see that our estimated credit losses for '08 have increased to 16 basis points, with our own line estimate increasing to a range of 20 to 25 basis points respectively. Just to be clear, our 2009 estimate for total credit losses now includes the effect of our expected 2008 new business.

Finally, slide seven, shows that despite the continued high-level of charge-offs we remain very adequately reserved for our expected losses. As of the end of March, our ratio of reserves to expected charge-offs was 1.6 times, consistent with where we were at year end. Another way to think about reserve coverage is as a ratio to recent period losses. On this metric, our reserve to annualized first quarter charge-offs is about 1.6 times.

One final point before I turn things over to Patti. We did not take any impairments on our ABS portfolio in the quarter. As we've discussed in the past, we perform a very rigorous security-by-security analysis and given both our intent and our ability to hold securities until maturity, we have not identified any securities where losses are probable. We're watching all aspects of our ABS holdings very closely, in particular, a limited subset of our holdings, including a small percentage of our all day securities, and a few hundred million dollars of originally AAA-rated securities backed by second liens. Likewise, a subset of our holdings are backed by monoline insurers which is factored into the recovery expectations for those securities. At this point we are not expecting to impair any material amounts of our ABS portfolio, over the next several quarters, this evaluation is done on a quarterly basis, and could change as market continues evolve, or if the realized or expected performance of individual securities significantly deteriorates.

So to sum it up, from a financial perspective, the key take aways for the first quarter are - credit costs are up but manageable, interest and credit mark sensitivity have greatly improved, we are expecting significant revenue growth for the balance of the year, and the combination of our existing capital base, our capital raise, and the regulatory relief, puts us in a very strong capital position. With that, let me turn things over to Patti.

Patti Cook - Freddie Mac - Chief Business Officer

Thanks Buddy. The first quarter continued to present us with significant house price declines, fallen financial markets, and significant credit losses. However, unlike prior periods the opportunities to deploy at very attractive returns and support the mortgage market were many. My comments will focus on the steps Freddie Mac is taking to manage through the turmoil and the actions we are taking to improve future results. I want to highlight four things in particular.

First, the house price correction is happening more quickly than we expected, which contributed to us raising our expectations for total default cost. While we are not yet ready to change our national peak to trough estimate, of a bit over 15%, the risks, as Dick mentioned, are clearly to the downside. Second, continued high GSE market share coupled with improvements in credit quality and pricing, makes the forward-looking returns in our single-family, and multifamily businesses more attractive.

Third, resumed growth in the retained portfolio at wide nominal and OAS spreadswill generate very attractive returns, and NIM growth in our investment business. Finally, to ensure that we remain able to meet the liquidity, stability, and affordability needs of the mortgage market through growth in all three of our businesses, we are preparing to raise an additional \$5.5 billion in capital.

So first, the decline in house prices in the first quarter, and the impact on credit. I'll refer you to slides eight and nine. According to our own index, house prices declined 4.2% in the first quarter, bringing the realized quarterly peak to trough decline to about 9%. This includes regional realized declines of as much as 20% plus in California and Nevada, and 16% in Florida. In considering an adjustment to our total decline, we would first like to see how the second quarter develops for home prices, a season typically

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more favorable for housing. It also appears that the outlook for the economy in financial markets may be showing signs of improvement, as unemployment has remained relatively stable, and financial institutions have significantly recapitalized. These factors also play a role in expected defaults.

Given that there is downside risk to our house price forecast, I want to take a couple of moments about the connection between house price declines and expected default costs. First, the speed of decline affects the total EDC. So as I just mentioned, the rapid decline we saw in the first quarter, all else equal, raises the EDC estimates. Second, we use a model to estimate our expected default costs over the life of the loan. To a Monte Carlo simulation around a base case house price pass, the model produces an estimate of life-time expected default. We can evaluate the default in severities the model produces in the context of historical data and current delinquency information to discern the reasonableness of the output.

Given the unusual times we're in, it is important to recognize the uncertainty inherent in these estimates. For example, a mid-teens peak to trough house price path could produce defaults of 4% and severities of 30%, which is high by historical comparison, resulting in about \$18 billion of EDC. In consideration of further house price declines, but in recognition of the unusual relationship today between house prices and the economy, we would view a range of \$15 billion to \$20 billion EDC, as a reasonable current estimate.

Third, we have disclosed that a 5% reduction in house prices increases our EDC by about \$5 billion, so if you want to consider a bigger drop in house prices, you can use that relationship to estimate the increase in total EDC. Remember that these losses will occur over several years. And lastly, even with defaults of 6% on the entire portfolio and severities of 3.5, similar to what was realized in California in the early '90s but for the entire portfolio, we could manage the resulting losses which would approximate the fair value of our GO, with the intended capital raise, and revenue growth.

Moving on to the credit losses we are realizing in our portfolio, I'll refer you to slide 10. They are recurring for one of two principal reasons. Either they are loans in regions with depressed economies like Michigan and Ohio, or they are in regions with rapid house price declines and a high percentage of loans with the combination of high total loan to value ratios, low FICO scores, and little documentation, like California and Florida. As you can see on line 15, the eight worst performing states in our 2006 book, represent about 80% of 2006 losses in the first quarter. 2007, which is not shown here, has very similar characteristics. While stress in the mid-western states has been observable for a couple of years, the rapid emergence of default and delinquencies in the rapidly declining states is a new phenomenon and associated primarily with our 2006 and 2007 originations.

As you can see on the top of slide 10, about half of our first quarter realized losses came from those two book years, and we expect future losses to continue to be disproportionately related to 2006 and 2007 originations. Detailed analysis of the 2006 book has allowed us to attribute this poor credit performance to certain risk variables, for example, low FICO scores, high TLTVs and low documentation loans, as I mentioned earlier. This formed the foundation for the risk based delivery fees we have introduced over the last several months, and which will be fully effective by the end of the second quarter.

In addition to these increases, we also tightened some credit terms. On slide 11 you can see how these changes have dramatically reduced the proportion of our deliveries with low FICO scores, high TLTV, loan documentation, and loans that have second lien exposure, since the peak in September or October of last year. As a result of these changes, the expected lifetime default cost, on the worst quintile of new guarantees, has fallen by more than 40% from its peak. We believe these changes to our terms of business, will allow us to provide the liquidity the mortgage markets need in a responsible risk-disciplined way that is enduring.

So while credit losses will continue to be a drag on earnings for several quarters, the underlying fundamentals of our business have greatly improved. Beginning in early 2007, as other mortgage investors were trenched, our penetration of the conventional conforming market increased. The GSE share rose from 39% in the first quarter in 2006, to more than 80% at March 31, as shown on slide 12. Initially this increase in share wasn't at attractive terms. The credit quality was worse, and we weren't getting paid for the additional risk. However, with the tightening of terms, and the increases in fees that we have begun to implement, the expected returns on our current flow, are substantially better. We would expect g-fees on fourth quarter volumes to be around 25 to 30 basis point, depending on the mix of business. This is down slightly from the level we discussed on our investor day,

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primarily based on our expectation of the credit quality of new deliveries for the remainder of the year. While all-in reported g-fees on our total portfolio climbed to more than 20 basis points in the first quarter, up from 18 in the fourth, the majority of this increase reflects product mix and stepped up amortization of deferred fees. So as our old book runs off, and 2008 deliveries come on at higher fees, we should naturally see our all in g-fees migrate higher.

Coupled with our expectation for guarantee portfolio growth for 2008, this should produce revenue growth of 15% to 20% for the year. While much smaller in dollar volume, the multifamily business has enjoyed a similar resurgence. Higher volumes, better pricing, and better terms. This adjustment allows us to provide the liquidity needed in this market.

Let's return now to the retained portfolio, slide 13. This is one area where our strategy has changed meaningfully since the investor day. While our purchase activity picked up significantly in late February in response to the widest spreads we had seen in decades, the improved outlook on the capital front resulting from the reduction in the capital surplus, the planned capital raise, and the improved GAAP income picture, allowed us to maintain this more active posture, and begin to grow our retained portfolio. The left-hand panel in slide 13, shows the surge in commitments that has occurred in March, and then again in April. Most of these will settle in the next couple months, producing sharp growth in our settled portfolio balance. As with the guarantee business, these volumes have come at increasing levels of profitability and provide a material support to mortgage market liquidity.

The graph on the right shows the LIBOR OAS levels for plain vanilla agency fixed-rate and floating-rate securities between July of 2007 and today. An important point to note is that while the graph shows directionally where spreads have gone, we have done better both because our debt funds below LIBOR, and because we can concentrate our purchases in the specific products that provide the best risk-adjusted returns.

From early March through mid-May, Freddie Mac entered into approximately \$100 billion in new purchase commitments, including both fixed- and floating-rate agency mortgage securities. The purchases executed during March and April were done at average levels of about 90 basis points of agency OAS, and initial GAAP NIM of about 150 basis points. Since GAAP NIM does not reflect our long-term funding cost, or the cost of hedging interest risk, it is higher than the OAS. Based on the increased availability of capital, and attractive opportunities, we expect to grow the portfolio significantly in 2008. And that has continued to support the liquidity and stability of the mortgage market. Putting volume and price together, we estimate that the effect of new portfolio adds, should be in the range of 40% to 50% revenue increase, from net interest income in 2008 versus 2007.

So to sum up, while house price declines have led to continued credit losses, the improvement in our underwriting standards, increased pricing and guarantee fees, growing retained portfolio purchases, and significantly higher ROEs on new business, give us confidence in the future return prospects for Freddie Mac. The additional release of regulatory capital surplus announced today by a regulator, and the issuance of \$5.5 billion in securities, will provide for flexibility and growth in our business.

With that I'll turn it over the Dick.

Richard Syron - Freddie Mac - Chairman, CEO

Well thanks Patti. We've taken a lot of your time talking at you, so I'll try to be very, very quick. First, as far as the broad political and economic environment goes, I think the big picture is that more than at any time, at least since I've been here, the GSEs are understood to be a vital part for solving the nation's housing crisis, affecting homeowners and the broader economy. In this environment, we have sought to link the importance of our ability to attract shareholder capital, with our ability to serve a vital housing mission. We are hopeful about the process and continue to support sound legislation going forward.

Turning back to the business, we have tried to set forth a clearer picture for you. It's plain we've reduced our losses in the fourth quarter considerably. And with the benefit of our improved financial reporting, all you have to do is look under the hood to see that our 2008 book of business, and going forward, is on track to be much higher in quality, larger in volumes, increasing in

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guarantee returns, and wider in investment spreads. Simply put, we are confident that the capital we are raising will enable us to both advance our mission and increase our returns to shareholders. So, yes, our credit losses are increasing in this environment, but they are concentrated, and we believe under any reasonable scenario, manageable and mitigated by attractive revenue growth going forward. Thanks very much for your time.

Ed Golding - Freddie Mac - SVP, IR

Operator, may we have the first question please?

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Our first question comes from the line of David Hochstim, with Bear Stearns. Please go ahead.

David Hochstim - Bear Stearns - Analyst

Thank you, hello. I was wondering if Buddy, or someone could talk about slide 26 - just the reconciliation between GAAP managed income, and the adjusted net interest income, and the changes in derivative expense, and whether those are kind of one time items related to market volatility, or are those recurring? I guess I'm trying to understand the guidance about net interest income growth. I guess maybe that was GAAP net interest income, but how do we think about adjusted net interest income over the course of the year?

Buddy Pizsel - Freddie Mac - CFO

Sure David. One of the most difficult things we had in putting together the adjusted version of our earnings, was trying to figure out how to look at our hedging activities and amortize that on a ratable basis with the emergence of the earnings that were being hedged. We do a very detailed instrument-by-instrument, transaction-by-transaction, amortization process. When we came out with this, and we showed the last you know eight quarters, you know the process we used worked pretty well. And it looked like there was stability in it.

Now in the first quarter, we found out for the first time it doesn't work as well as we thought. And so there is some disruption, from the way that we're amortizing the derivatives, but there's a couple real things going on too. So I mentioned the spread compression from the short assets versus the short liabilities. That also affected the AOI NIM. Secondly, we are hedging. We ramped up commitments big in the first quarter, and we started to take the loss on the carry on those hedges in the first quarter. That dampened the NIM on this schedule. And lastly, due to the way that we do hedges, some of the short-term hedges that we entered into, the gains on those got pushed to the second quarter from the first.

So this is a little distorted compared to where we would expect it to be. If you looked at it on a full-year basis, it will recover close to where we were in the previous quarters, and then it will start to grow, as overall spreads improve and as the growth in the portfolio improves. So this is an anomaly for the quarter.

David Hochstim - Bear Stearns - Analyst

Okay, and then the follow-up would be, I guess Patti, is there anything you can tell about capacity to issue large quantities of debt to fund the purchases that you see in the market now, and very attractive spreads?

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Patti Cook - Freddie Mac - Chief Business Officer

Yes, I mean one of the resilient aspects of being a GSE, is that the asset, is the availability to funding. So if you look at our debt spreads, and let's look at the long end of the curve first, and you look at 10-year notes, there was a period where our 10-year debt got to LIBOR to plus 45. It was a short period of time, and I would say right now it goes back and forth, plus or minus LIBOR. On the front end of the curve, our short term debt has continued to be placed at levels substantially below LIBOR, LIBOR minus 50 basis points. So we remain quite confident about our access to the debt market at levels that are attractive relative to LIBOR.

David Hochstim - Bear Stearns - Analyst

Okay thanks.

Operator

Our next question comes from the line of Howard Shapiro, with Fox-Pitt, please go ahead.

Howard Shapiro - Fox-Pitt Kelton - Analyst

Hello thank you. First of all congratulations on an excellent quarter. It definitely seems like you turned the corner. I wanted to just ask a question on the mark-to-market volatility. Buddy, I think you said there is still some more to do, in terms of adopting hedge accounting treatment, and that it would further reduce the volatility. Can you just tell us where you are in the process? What more needs to be done, and would that bring the kind of volatility range below the \$1 billion you have been talking about, or is that still what we should be looking at? Thanks.

Buddy Pizel - Freddie Mac - CFO

Howard, so two points. One is, by the end of the first quarter, we had only been able to put on about \$4 billion notional of hedge positions for accounting purposes. And we've increased that substantially. So I think as of right now, we're sitting with you know north of \$13 billion. So we have ramped that up. And we need to continue to ramp that up because we're growing the portfolio fairly substantially. So I don't think we're going to get beyond a billion. I would still keep the billion. But you can see as of the first quarter, we were north of that. So that is why I said, we have more work to do.

Howard Shapiro - Fox-Pitt Kelton - Analyst

Okay great, thanks.

Operator

Our next question comes from the line of Paul Miller, with FBR Capital Markets. Please go ahead.

Paul Miller - FBR Capital Markets - Analyst

Yes, thanks very much. There's a headline out there, talking about Freddie Mac level three assets of \$157 billion and I don't see that in any of your releases. I was just wondering is that true, and where did that number come from, and is that related at all to the markups of the trading securities on page four of the \$1.2 billion gain?

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Buddy Pizel - *Freddie Mac - CFO*

No, it is not Paul. We made a determination in the first quarter, that given how widely the pricing we were getting on the ABS portfolio, that it no longer made sense to leave that into level two. So we essentially moved the entire ABS portfolio into level three. We were still using the mean price that we were getting from the pricing services, and the dealers. So we're not using a model price. But that is what all of that is. It has nothing to do with the trading portfolio.

Paul Miller - *FBR Capital Markets - Analyst*

Okay, thank you very much.

Operator

Our next question comes from the line of Brad Ball with Citi, please go ahead.

Brad Ball - *Citigroup - Analyst*

Yes, actually a follow up on the ABS portfolio Slide 21, I wonder if you could just spend a few minutes describing what is in there, and if there are any major changes versus the presentation in the fourth quarter? And what gives you confidence that there are not any permanent impairments in the subprime ABS?

Buddy Pizel - *Freddie Mac - CFO*

Brad as I said, our view of the subprime portfolio has not changed. So this does not reflect a deterioration, or a change in our expectations. What I liked about this slide, is it just reflects how well protected the subprime portfolio is. And if you look on the most right-hand side, there is a percentage of the securities that you cannot model a loss on. And then as you go across the page you can see the level of defaults that you have to incur in order to penetrate the protection that is there.

So we continue to do a very, very rigorous evaluation, security by security. Our expectations are that we are not going to have impairments in this portfolio without dramatic degradation of credit from where it is today. And we still feel pretty good. So no changes at all in the way we think about things. We just thought this slide was helpful to sort of put this in perspective.

Brad Ball - *Citigroup - Analyst*

Okay, great. And just a quick question on the capital raise. You said you had looked to do roughly half of the \$5.5 billion in the straight preferred market. Just roughing the numbers out, that probably means that your preferred to total capital would be approaching 40%. Is that a level at which the regulator or the agencies are comfortable? How do you feel about the preferred-to-total capital amount?

Buddy Pizel - *Freddie Mac - CFO*

You know Brad we're clearly at the high end of where this should be on sort of a steady state basis. When we thought about what we were going to do- we certainly took that into consideration. We did have discussions with the rating agencies. And part of this, is sort of what's your plan to get back to the 25% to 30% range that I think long term, should be the way that we look at our capital structure. And given earnings projections, or the way we see things playing out, you're in a two to three year period to get back to normal, and we think that's reasonable, given the period we're going through right now.

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Brad Ball - Citigroup - Analyst

Okay great thanks.

Operator

Our next question comes from the line of Bob Napoli, with Piper Jaffray, please go ahead.

Bob Napoli - Piper Jaffray - Analyst

Thank you and good morning. The question is on delinquency trends within your portfolio. I think this is page 18 within the summary of selected financial information. If you look at the trend, obviously foreclosures are up dramatically and continued even in the first quarter to spike, but the delinquencies stabilized in the first quarter. But seasonally, credit quality tends to stabilize in the first quarter, even had a decline in the southwest. And the increase in the west was a lot less than it was the prior quarter. I just-- are you seeing signs overall, that there is stabilization in credit? Obviously delinquencies have to slow before foreclosures slow, or is this a seasonal event?

Patti Cook - Freddie Mac - Chief Business Officer

I would say, Bob, it is a little early to say we're seeing stabilization in credit. I think the rapid rate of house price declines in the first quarter actually gave us reason to increase the lifetime expected default cost. Now how that emerges quarter to quarter through our delinquencies, our severities and our charge-offs is going to be a little different. But I think it's too early to say that we've seen stabilization.

Bob Napoli - Piper Jaffray - Analyst

Okay, how does April look versus March on the delinquency front for you guys in May to date?

Patti Cook - Freddie Mac - Chief Business Officer

I don't have good statistics at this point, for the month of April that I can share on the call.

Bob Napoli - Piper Jaffray - Analyst

And then just my last question, Patti, you had given a kind of overview of what you thought, was a reasonable worst case credit scenario. And I was hoping you could kind of go through that.

Patti Cook - Freddie Mac - Chief Business Officer

What I wanted to point out, is we tried to give guidance, on what we think our total present value of future default costs is likely to be. So that would allow you to kind of look at current charge-offs and put it in context of long-term expectations. So that's when I refer to a range of \$15 billion to \$20 billion, trying to put in context, what that means.

So the point would be this. If you were forecasting mid-teens reduction in house prices, we run that through a model, Monte Carlo simulation, so there's downside and upside relative to that. And what comes out of the model, is an expected EDC number, with certain defaults and certain severities. My point is that when you use that model today, you're getting defaults and severities

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that are pretty high by historical standards, 4% defaults, 35% severities. So I'm just trying to put in context, the connection between house prices, the resulting EDC number, the uncertainty around the measure, and yet the confidence that we have the ability to manage to those level of defaults, through the combination of capital and future growth in revenue.

Bob Napoli - *Piper Jaffray - Analyst*

And if you translated that into your guidance for credit losses for 2009 into a worst case?

Patti Cook - *Freddie Mac - Chief Business Officer*

They're consistent. So the long-term expectation of a \$15 billion to \$20 billion range is consistent with the total credit losses as they're emerging through GAAP. They're connected.

Bob Napoli - *Piper Jaffray - Analyst*

Thank you.

Operator

Our next question comes from the line of Fred Cannon, with KBW, please go ahead.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

Thanks. I note that the deferred tax asset jumped by a little over \$6 billion in the quarter and is now greater than the shareholders' equity. And I was wondering if a lot of that increase had to do with the growth in OCI, and what some of the other factors might have been? And also is there a risk of needing to take a valuation allowance against that deferred tax asset, given its size?

Buddy Pizel - *Freddie Mac - CFO*

Fred, you hit it. The growth in it is related to taking - just think about it. The amount of marks that we've taken that were unrealized marks between '07 and we've continued to do it in '08, is really what's driving the size of the deferred tax asset. So a couple of points to make around that. First of all, you know we have represented on every call, that we think that the marks are not representative of real, true, expected cash losses, and so as things revert to normal, they won't just naturally revert, and you will be recovering that deferred tax asset.

Secondly, even if you assume that they were all going to result in real losses, when you project out our taxable income, we have never had a year when we did not have taxable income. And we don't project a year now, where we don't have taxable income. So between carry-back and carry-forward, there is no exposure to us not realizing our deferred tax asset.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

Right, okay, thanks. And one follow-up to David's question on adjusted operating income. It may be just a clarification. You kind of restated that, and you're calling it total segment reporting income, I believe, now. And it swung from a positive in the fourth quarter, to a negative in the first quarter. And if I remember the investor day, you kind of encouraged us to look at that metric as kind of a true representation of, kind of what's going at the company. I was wondering if we should, some of the things that you're talking about, should we back away from using that metric, or is this kind of a one-time issue where it turned negative?

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Buddy Pizel - *Freddie Mac - CFO*

I would say two things. First of all we had to change the name, because it was going through the SEC process. The SEC didn't like adjusted operating income, so I have to stop using it, and thank you for catching me on that. So it will be segment earnings going forward.

Secondly the only thing that is a little off in AOI for this quarter is the anomaly of that - I spoke about that earlier, on the NIM, other than that, it would be down in the first quarter, because the provisioning is much higher. So if you look at the g-fee business, it actually looks the way we think is reasonable. The retained portfolio business is a little understated, because we suppressed the NIM recognition, and multifamily looks about right. So I think it is still a relevant and a good measure. It will make a little bit more sense after you get a couple quarters averaged together.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

Great, thanks Buddy.

Operator

Our next question comes with the line of Gary Gordon, with Portales Partners, please go ahead.

Gary Gordon - *Portales Partners - Analyst*

Okay thanks. Two questions, one, again unfortunately on accounting on page three, you show mark-to-market about a \$1.4 billion loss, back to the segment reporting--

Patti Cook - *Freddie Mac - Chief Business Officer*

We're losing you.

Richard Syron - *Freddie Mac - Chairman, CEO*

We lost you. Hello?

Gary Gordon - *Portales Partners - Analyst*

Can you hear me now?

Patti Cook - *Freddie Mac - Chief Business Officer*

Yes, we can hear you.

Buddy Pizel - *Freddie Mac - CFO*

Start again Gary.

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Gary Gordon - Portales Partners - Analyst

Okay sorry, okay on another accounting question, page three you show a mark-to-market loss of \$1.4 billion. When you get to the segment reporting it's zero. So I'm wondering if - how do the mark-to-markets work their way into the segment reporting? And then a follow-up question.

Buddy Pizel - Freddie Mac - CFO

So in the segment reporting what we're doing is we are not reporting marks. But instead, we're reporting the cost of the derivative. The real cost of the hedging activity, amortizing against net interest income over the entire period. So it is literally an instrument by instrument. The real cost of hedging is being amortized against net interest income and the temporal marks are disregarded because if you think about what we're doing, we are economically hedging the portfolio. And the right way for the earnings to emerge, is to reflect the hedging costs as your earnings emerge, so it's a different model, so you don't have the same kind of bouncing around from derivative marks, that you'll see in our GAAP side.

Gary Gordon - Portales Partners - Analyst

Sounds like then though, the \$1.4 billion of marks up front, some roughly reflect sort of accrual charges that you're making in the segment reporting?

Buddy Pizel - Freddie Mac - CFO

Yes, there is, included in the \$1.3, there's about \$340 million of derivative carry, and that is included in the segment reporting. And additionally, there is the carry from previously closed out hedges that we're also running through.

Gary Gordon - Portales Partners - Analyst

Okay thanks. The follow-up question is on your purchase, I believe for portfolio. I believe I heard you say you bought the bulk of your purchases for the year already, the \$100 billion you talked about. Is that accurate? And obviously, it seem there is a correlation between your commitments and OAS spreads, if you're largely most of the way through your purchases, what potential impact does that have on OAS spreads?

Buddy Pizel - Freddie Mac - CFO

Let me address the - we're largely through. We're not largely through, but what we did, is we started early. So we made \$100 billion of purchases, which is way above what we normally would have been purchasing on a monthly basis. So we've already sort of gotten into the portfolio. So we'll start to generate the income faster. That does not mean we're not going to continue to grow. So we've done a big deposit on the growth in the retained portfolio as we said today, and we'll get the whole benefit of that in the second half of the year.

Patti Cook - Freddie Mac - Chief Business Officer

Yes, looking forward you know we will continue to provide liquidity to the mortgage market, as sort of - as it needs it. And you know there is a high correlation between the wide spreads and the need for that liquidity. So our activity in the market is going to be correlated with your observation on the wider spreads. And hopefully by virtue of that activity, as well as the market's expectation for the continued activity, it provides good support in the secondary market for mortgage spreads.

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Gary Gordon - Portales Partners - Analyst

Okay, thank you.

Operator

Our next question comes from the line of Moshe Orenbuch, with Credit Suisse. Please go ahead.

Moshe Orenbuch - Credit Suisse - Analyst

Buddy, you had alluded to the fact that you thought you were ahead of schedule on the SEC registration. Could you kind of elaborate a little bit on that, because the appendix you put out showed that there still were some control areas that needed to be remediated. What has to be done between now and then, what the process is going to look like?

Buddy Pizel - Freddie Mac - CFO

Yeah, sure, Moshe, we said that we were targeting mid-year '08 to be a registrant. We have you know made a lot of progress with the SEC. They have given their feedback, we've responded as to the changes we would be making, related to our year-end disclosures. And we are sort of going through and completing the comment process. So you know-- Yes. From that standpoint, you know we're pretty close to the finish line, on being able to finalize the feedback from the SEC, and with that, you know register. So we are ahead of schedule from that standpoint. As far as the outstanding control points, they're really not a factor in becoming an SEC registrant. You can register with control issues. Now I will say, we have remediated all of the significant ones. So the material weaknesses are all remediated and having a handful of significant deficiencies, every single financial institution has a handful of significant deficiencies, we're no different than anybody else. I'd say in a lot of respects, we probably have fewer, than many companies. So that is no longer an issue, and has really has nothing to do with our registration timing.

Moshe Orenbuch - Credit Suisse - Analyst

So you would expect to have their comments back, and be able to respond to them-- refile by June 30?

Buddy Pizel - Freddie Mac - CFO

We clearly should be in that position by the end of June, if not sooner.

Moshe Orenbuch - Credit Suisse - Analyst

Okay. And could you just talk about the process for the capital raise and you have raised at least preferred, prior to you know being - prior to being registered?

Buddy Pizel - Freddie Mac - CFO

The reason we would wait, Moshe is - you would never want to be in a position where, even though it is unlikely, there could be something in resolving things with the SEC, that you wouldn't want to do a capital raise, without finishing that process. And just from a risk to the franchise standpoint, we don't want raise capital unless our disclosures are pristine, and completely supported by a thorough review by the SEC. And we just think that makes good sense.

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Moshe Orenbuch - *Credit Suisse - Analyst*

Thank you.

Operator

Our next question comes from the line of Bruce Harting, with Lehman Brothers. Please go ahead.

Bruce Harting - *Lehman Brothers - Analyst*

Buddy, I just wanted clarify, have you said in the past that your target is to make this year's provisioning your peak year? And I could be wrong on that comment. But if you did say that, is that still the case? And if you didn't, any comment on that.

Buddy Pizel - *Freddie Mac - CFO*

I think we did say that. When we looked at this originally, Bruce, I think we had '08 being the peak, and '09 being a little less, but not a lot, with our increase in '08, it's still by our own reckoning, would be the peak, but '09 goes up too. The hill got a little - it plateaued a little bit longer, and then 2010 is dramatically lower. So it is really like two years of pretty heavy provisioning. But again, given the expected revenue growth, we are in a very good position to be able to manage through that.

Bruce Harting - *Lehman Brothers - Analyst*

And then the basis point guidance your giving, is that specifically charge-offs? Does that include REO expense also, and could you just segment the various costs, and what it doesn't include?

Buddy Pizel - *Freddie Mac - CFO*

Yes, it does include REO expense, that is what we call total credit costs. One thing I would say, if you look historically with the relationship between REO and charge-offs, it's a little aberrant in the first quarter, because in the first quarter, we adjusted - we took about \$115 million adjustment to our REO expense to catch up on the severities that we're seeing, based on the inventory. So it is a little higher than normal. It will revert back to normal if you think about the full-year guidance. And that ratio should be about right going forward.

Bruce Harting - *Lehman Brothers - Analyst*

Okay, and then my last question is in terms of the excess capital decreases that are pending, and the amount of capital that you're raising, you're at about \$14 billion, \$15 billion of excess capital, by say September. And you know it seems like the pro-cyclical nature at the bottom, or at the worst part of the cycle raising capital, and building reserves, the question would be sort of based on the strong growth that you're targeting, you still, by my calculation it only uses about maybe \$3 billion to \$4 billion of capital over the next 12 months. So you're still going to be in a very significant over capitalization situation say, by mid-to late '09, as credit costs hopefully peak, and start to come down. And it seems like there's other redundancies in terms of reserves. I know it's early days to start thinking about how to deploy those redundancies, but you know by 2010, what would likely give in terms of some of these reserve redundancies and excess capital, or would you really just grow your way into the excess capital, or are you thinking that some of the preferred, might have a non-call two or three feature, that sort of thing? Thanks.

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Buddy Pizsel - *Freddie Mac - CFO*

Let me start, and then others can chime in. We are deliberately putting ourselves in a very, very strong capital position. I think your observation is right, that even with the kind of growth that we're anticipating, we'll end the year in a very strong capital position. We are doing this capital raise, to make sure that even if credit goes, way worse than we're currently expected, we have got the capital position to be able to sustain that.

You're right also, that once you get if, in fact, things go the way we're planning, if at some point you can get back to a more rational capital structure. If we can grow our way -whether we can grow our way to absorb that, depends on where the spread opportunities are. And if they're not there, then over time we're going to have to get our capital structure back in line. And that's the way we would look at it, but I think at this point we're better off being in a very, very strong position, than hoping for the best. So that's the way we're thinking about it.

Bruce Harting - *Lehman Brothers - Analyst*

Thank you.

Operator

Our next question comes from the line of David [Dutenbary] with W.W. Grainger Please go ahead.

David Dutenbary - *W.W. Grainger - Analyst*

Hi there. Just a quick question on your guidelines - or not guidelines, but just your direction in terms of house price decline, and the impact on the credit cost. Have you looked at the impact that LTVs, rising LTVs have on the projected credit cost? In other words, as people get close to the end, and then get under water, the propensity for them to default, does that go up geometrically, and is that captured in your numbers?

Patti Cook - *Freddie Mac - Chief Business Officer*

Yes, clearly it is. And you know, you have identified one of the key attributes, if you will of the loans in '06 and '07 that are contributing to the higher defaults. As I think I mentioned in my prepared remarks, that has led us to do a couple of things - to look hard at what the maximum TLTV is we're willing to purchase, and it also, resulted in our raising delivery fees on that portion of the population. So it clearly is contributing to higher expected default costs. It is captured in our numbers. And we have responded with both tightening of terms and raising of prices.

David Dutenbary - *W.W. Grainger - Analyst*

What have you seen, just out of curiosity, is it in line with historical default rates as they get under order or does it - ?

Patti Cook - *Freddie Mac - Chief Business Officer*

No it's different. The rate of increase in default in that part of the population is much steeper. If you think about it, I'd summarize it this way, for those borrowers that bought a home based on rapid house price depreciation as a way to grow wealth, if they find themselves quickly under water, we're even seeing it when we go and try and modify or renegotiate those loans. They're walking away. They're finding it not constructive. So I do think the ramp in defaults for that portion of the population is steeper than historical observation. And we are reflecting that in our expectations.

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David Dutenbary - *W.W. Grainger - Analyst*

Great, thanks a lot.

Ed Golding - *Freddie Mac - SVP, IR*

Operator may we take one more question, please.

Operator

Yes, our final question comes from the line of Howard Shapiro, with Fox-Pitt. Please go ahead.

Howard Shapiro - *Fox-Pitt Kelton - Analyst*

Hello, this is just a follow-up for Patti, on the EDC discussion. I'm trying to understand. You have got the GO on the balance sheet right now at about \$13 billion or so. And I'm assuming that is the expectation of future losses over time. But you're saying kind of a base case in your Monte Carlo simulation is \$15 billion to \$20 billion of losses. Is the GO reflecting a lower level of losses, or am I misunderstanding that in the relationship?

Buddy Pizel - *Freddie Mac - CFO*

The GAAP based GO is not a reflection of expected credit losses Howard. What you have to do, if you want to get sort of the market's view of sort of expected credit losses, you look to the fair value GO, which I think was the number that Patti was referring to.

Patti Cook - *Freddie Mac - Chief Business Officer*

And that number is closer to \$30 billion.

Howard Shapiro - *Fox-Pitt Kelton - Analyst*

Okay, perfect, thank you very much.

Patti Cook - *Freddie Mac - Chief Business Officer*

You're welcome.

Richard Syron - *Freddie Mac - Chairman, CEO*

Well thank you all very much. We appreciate you taking as much time as you have with us this morning. And if there are further questions you know how to pursue them with Ed Golding.

Ed Golding - *Freddie Mac - SVP, IR*

Operator could you give us the replay number and information?

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Operator

Ladies and gentlemen this conference will be available for replay, beginning today at 12:30 pm Eastern, running through May 28 at midnight. The dial in numbers for the replay are 800-475-6701. International participants should dial 320-365-3844 with the access code of 919633. Once again the conference will be available for replay beginning today at 12:30 pm Eastern, running through May 28 at midnight. Again those dialing numbers are 800-475-6701. International, 320-365-3844, with the access code of 919633. That does conclude our conference for today. Ladies and gentlemen, thank you for your participation. You may now disconnect.

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