FEDERAL HOME LOAN MORTGAGE CORP
Form 10-Q
August 06, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the quarterly period ended June 30, 2008

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the transition period from to

Commission File Number: 000-53330

Federal Home Loan Mortgage Corporation
(Exact name of registrant as specified in its charter)

Freddie Mac

Federally chartered corporation *(State or other jurisdiction of incorporation or organization)*	**52-0904874** *(I.R.S. Employer Identification No.)*
8200 Jones Branch Drive, McLean, Virginia *(Address of principal executive offices)*	**22102-3110** *(Zip Code)*

(703) 903-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. o Yes x No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of accelerated filer, large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o

Non-accelerated filer (Do not check if a smaller reporting company) x Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes x No

As of July 28, 2008, there were 647,015,161 shares of the registrant s common stock outstanding.

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FINANCIAL STATEMENTS

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PART I FINANCIAL INFORMATION

This Quarterly Report on Form 10-Q includes forward-looking statements, which may include expectations and objectives related to our operating results, financial condition, business, capital management, remediation of significant deficiencies in internal controls, credit losses, market share and trends and other matters. You should not rely unduly on our forward-looking statements. Actual results might differ significantly from those described in or implied by such forward-looking statements due to various factors and uncertainties, including those described in (i) MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, or MD&A, FORWARD-LOOKING STATEMENTS and RISK FACTORS in this Form 10-Q and in the comparably captioned sections of our Form 10 Registration Statement filed and declared effective by the Securities and Exchange Commission, or SEC, on July 18, 2008, or Registration Statement, and (ii) the BUSINESS section of our Registration Statement. These forward-looking statements are made as of the date of this Form 10-Q and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date of this Form 10-Q, or to reflect the occurrence of unanticipated events.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

EXECUTIVE SUMMARY

Freddie Mac is a stockholder-owned company chartered by Congress in 1970 to stabilize the nation s residential mortgage markets and expand opportunities for homeownership and affordable rental housing. Our mission is to provide liquidity, stability and affordability to the U.S. housing market. We fulfill our mission by purchasing residential mortgage loans and mortgage-related securities in the secondary mortgage market. We are one of the largest purchasers of mortgage loans in the U.S. We purchase mortgage loans and bundle them into mortgage-related securities that can be sold to investors. We can use the proceeds to purchase additional mortgage loans from primary market mortgage lenders, providing these lenders with a continuous flow of funds. We also purchase mortgage loans and mortgage-related securities for our retained portfolio. We finance our purchases for our retained portfolio and manage associated interest-rate and other market risks primarily by issuing a variety of debt instruments and entering into derivative contracts in the capital markets. See CONSOLIDATED BALANCE SHEETS ANALYSIS Retained Portfolio and OUR PORTFOLIOS for a description and composition of our portfolios.

Though we are chartered by Congress, our business is funded completely with private capital. We alone are responsible for making payments on our securities. Neither the U.S. government nor any other agency or instrumentality of the U.S. government is obligated to fund our mortgage purchase or financing activities or to guarantee our securities or other obligations. Although the U.S. government s ability to provide financial support to us has recently increased, this has not changed our responsibility to fund our obligations or resulted in any guarantee of our securities or other obligations. See Legislative and Regulatory Matters.

Recent Events

Since mid-June 2008, there has been a substantial decline in the market price of our common stock. The market conditions that have contributed to this price decline are likely to affect our approach to raising new core capital including the timing, amount, type and mix of securities we may issue. We have committed to the Office of Federal Housing Enterprise Oversight, or OFHEO, to raise $5.5 billion of new capital. We remain committed to raising this capital given appropriate market conditions and will evaluate raising capital beyond this amount depending on our needs and as market conditions mandate.

Our financial performance for the second quarter, while reflecting the challenges that face the industry, leaves us capitalized at a level greater than the 20% mandatory target capital surplus established by OFHEO and with a greater surplus above the statutory minimum capital requirement. Given the challenges facing the industry, we expect to take actions to maintain our capital position above the mandatory target capital surplus. Accordingly, subject to approval by our board of directors, we currently expect to reduce the dividend on our common stock in the third quarter of 2008 from $0.25 to $0.05 or less per share and to pay the full dividends at contractual rates on our preferred stock. In addition, we continue to review and consider other alternatives for managing our capital including issuing equity in amounts that could be substantial and materially dilutive to our existing shareholders, reducing or rebalancing risk, slowing purchases into our credit guarantee portfolio and limiting the growth or reducing the size of our retained portfolio by allowing the portfolio to run off and/or by selling securities classified as trading or carried at fair value under Statement of Financial Accounting Standards, or SFAS, No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115,* or SFAS 159, or available-for-sale securities that are accretive to capital (*i.e.*, fair value exceeds amortized cost). We have retained and are working with financial advisors and we continue to engage in discussions with OFHEO and the U.S. Department of the Treasury, or Treasury, on these matters.

Our liquidity position remains strong as a result of: (a) our continued access to the debt markets at attractive spreads, (b) our cash and investments portfolio of approximately $70 billion and (c) an unencumbered agency mortgage-related securities portfolio of approximately $470 billion, which could serve as collateral for additional borrowings. Under stressful market conditions, counterparties willing to provide funding based on our unencumbered portfolio may be unavailable or may offer terms that are not attractive to the company. On July 13, 2008, the Board of Governors of the Federal Reserve System, or the Federal Reserve, granted the Federal Reserve Bank of New York the authority to lend to Freddie Mac if necessary. Any such lending would be at the discount rate charged for primary credit, or the primary credit rate, and collateralized by U.S. government and federal agency securities. This authorization was intended to supplement the Treasury s existing authority to purchase obligations of Freddie Mac.

The Housing and Economic Recovery Act of 2008 was signed into law on July 30, 2008. Division A of this legislation, the Federal Housing Finance Regulatory Reform Act of 2008, or the Regulatory Reform Act, establishes a new regulator for us, the Federal Housing Finance Agency, or FHFA, with enhanced regulatory authorities relating, among other things, to our minimum and risk-based capital levels and our business activities, including portfolio investments, new products, management and operations standards, affordable housing goals, and executive compensation. The Regulatory Reform Act expands the circumstances under which we could be placed into conservatorship and also authorizes the FHFA to place us into receivership under specified circumstances. The Regulatory Reform Act also requires us to allocate or transfer certain amounts to: (a) the Secretary of the U.S. Department of Housing and Urban Development, or HUD, to fund a Housing Trust Fund and (b) a Capital Magnet Fund administered by the Secretary of the Treasury. In addition, the Regulatory Reform Act provides the Secretary of the Treasury with temporary authority, until December 31, 2009, to purchase any obligations and other securities we issue under certain circumstances. See Legislative and Regulatory Matters for additional information concerning the provisions of the Regulatory Reform Act and their potential impact on us.

Market Overview

In the first six months of 2008, the single-family residential mortgage market has continued to experience deterioration that began during 2007. The various factors contributing to this deterioration have adversely affected our financial condition and results of operations. Specifically, our estimates of nationwide home price changes, which measure home values primarily based on repeat home sales indicated home price declines of approximately 1% and 5%, in the three and six months ended June 30, 2008, respectively, with significant variation across regions and metropolitan areas. Home price changes are an important market indicator for us because they represent the general trend in value associated with the single-family mortgage loans underlying our Mortgage Participation Certificates, or PCs, and other mortgage-related securities. As home prices decline, the risk of borrower defaults generally increases and the severity of credit losses also increases. Forecasts of nationwide home prices indicate a continued overall decline in 2008.

Other trends in the single-family residential mortgage market also reflect the weakening in the housing market. Since early 2006, the volume of new and existing home sales has declined and increased inventories of unsold homes have undermined property values. Demand for investor properties and second homes has also declined dramatically. Annual total single-family conventional mortgage originations are expected to continue to decline during 2008.

Credit concerns and resulting liquidity issues have also affected the financial markets. Since mid-2007, the market for non-agency mortgage-related securities has been characterized by high levels of uncertainty, reduced demand, illiquidity and significantly wider credit spreads. Non-agency mortgage-related securities, particularly those backed by subprime and Alt-A mortgage products, have been subject to rating agency downgrades and significant price declines in the market. The reduced liquidity in U.S. financial markets prompted the Federal Reserve to take several significant actions during the first half of 2008, including a series of reductions in the discount rate totaling 2.50%. In early March 2008, the Federal Reserve expanded its securities lending program to allow primary dealers to borrow

U.S. Treasury securities for 28 day terms (rather than only overnight) with a pledge of other securities by the borrower, including AAA-rated, private-issuer, residential mortgage securities. The Federal Reserve has left key lending rates unchanged since May 2008; however, credit and liquidity concerns have continued to affect the market.

The rate reductions by the Federal Reserve have had an impact on other key market rates affecting our assets and liabilities, including generally reducing the return on our cash and investments portfolio and lowering our cost of short-term debt financing. In addition, the reduction in rates by the Federal Reserve caused mortgage interest rates to temporarily decline early in 2008 and drove a surge in refinancing activity during the first four months of 2008. However, as residential mortgage rates rose during the remainder of the second quarter, the pace of refinancing activity slowed, and this is expected to also slow the growth of new issuances for our guaranteed PCs and Structured Securities portfolio during the second half of 2008.

The credit performance of mortgage products deteriorated during 2007 and 2008, most severely for subprime and Alt-A mortgage products. The decline in credit performance of mortgages during 2008, particularly subprime mortgages, has also impacted the ratings of certain monoline bond insurance providers, or monolines, which has negatively affected the pricing of non-agency mortgage and asset-backed securities in the market. We have direct and indirect exposure to monolines and recognized other-than-temporary impairment losses related to some of these exposures during the second quarter of 2008. See CONSOLIDATED BALANCE SHEETS ANALYSIS Retained Portfolio for additional information regarding our exposure to monolines as well as mortgage-related securities backed by subprime and Alt-A loans. Concerns about the potential for higher delinquency rates and more severe credit losses have resulted in greater increases in mortgage rates in the non-conforming and subprime portions of the market. Many lenders have tightened credit standards or elected to stop originating certain types of mortgages and several mortgage originators have exited the origination business. Decreases in home prices have also eroded the equity of many homeowners seeking to refinance. These factors have adversely affected many borrowers seeking alternative financing to refinance out of non-traditional and adjustable-rate mortgages, or ARMs.

The multifamily mortgage market differs from the residential single-family market in several respects. The likelihood that a multifamily borrower will make scheduled payments on its mortgage is a function of the ability of the property to generate income sufficient to make those payments, which is affected by rent levels and the percentage of available units that are occupied. Strength in the multifamily market therefore is affected by the balance between the supply of and demand for rental housing (both multifamily and single-family), which in turn is affected by employment, the number of new units added to the rental housing supply, rates of household formation and the relative cost of owner-occupied housing alternatives. Although multifamily market fundamentals have been strong in much of the nation, liquidity concerns and wider credit spreads have spilled over from the single-family mortgage market into the multifamily segment during 2008. However, we have continued to support the multifamily housing market during 2008 by making investments that we believe have attractive expected returns.

Summary of Financial Results for the Three and Six Months Ended June 30, 2008

Generally Accepted Accounting Principles, or GAAP, Results

Effective January 1, 2008, we adopted SFAS No. 157, *Fair Value Measurements,* or SFAS 157, which defines fair value, establishes a framework for measuring fair value in financial statements and expands required disclosures about fair value measurements. In connection with the adoption of SFAS 157, we changed our method for determining the fair value of our newly-issued guarantee obligations. Under SFAS 157, the initial fair value of our guarantee obligation equals the fair value of compensation received, consisting of management and guarantee fees and other upfront compensation, in the related securitization transaction, which is a practical expedient for determining fair value. As a result, prospectively from January 1, 2008, we no longer record estimates of deferred gains or immediate, day one losses on most guarantees. Our adoption of SFAS 157 did not result in an immediate recognition of gain or loss, but the prospective change had a positive impact on our financial results for the three and six months ended June 30, 2008.

Also effective January 1, 2008, we adopted SFAS 159 or the fair value option, which permits companies to choose to measure certain eligible financial instruments at fair value that are not currently required to be measured at fair value in order to mitigate volatility in reported earnings caused by measuring assets and liabilities differently. We initially elected the fair value option for certain available-for-sale mortgage-related securities and our foreign-currency denominated debt. Upon adoption of SFAS 159, we recognized a $1.0 billion after-tax increase to our retained earnings at January 1, 2008. We may continue to elect the fair value option for certain securities to mitigate interest-rate aspects of our guarantee asset and certain non-hedge designated pay-fixed swaps.

Net income (loss) was $(821) million and $729 million for the three months ended June 30, 2008 and 2007, respectively. Net income (loss) was $(972) million and $596 million for the six months ended June 30, 2008 and 2007, respectively. Net income decreased in the three and six months ended June 30, 2008 compared to the same periods of 2007, principally due to increased losses on investment activity as well as increased credit-related expenses, which consist of the provision for credit losses and real estate owned, or REO, operations expense. These loss and expense items for the three and six months ended June 30, 2008 were partially offset by higher net interest income and income on our guarantee obligation as well as lower losses on certain credit guarantees and lower losses on loans purchased due to our use of the practical expedient for determining fair value under SFAS 157 and changes in our operational practice of purchasing delinquent loans out of PC securitization pools.

Net interest income was $1.5 billion for the three months ended June 30, 2008, compared to $793 million for the three months ended June 30, 2007. Net interest income was $2.3 billion for the six months ended June 30, 2008, compared to $1.6 billion for the six months ended June 30, 2007. After the limitation on the growth of our retained portfolio expired, we were able to purchase significant amounts of fixed-rate agency mortgage-related securities at significantly wider spreads relative to our funding costs during the three and six months ended June 30, 2008. This action not only helped to serve our mission, but benefited our customers and the secondary mortgage market. The increase in net interest income and yield is also due to significantly lower short-term interest rates on our short-term borrowings and lower long-term interest rates on our long-term borrowings for the three and six months ended June 30, 2008. In addition, a higher proportion of short-term debt, together with a lower proportion of floating rate securities within our retained portfolio contributed to the improvement in net interest income and net interest yield during the three and six months ended June 30, 2008.

Non-interest income was $164 million and $895 million for the three and six months ended June 30, 2008, respectively, compared to non-interest income of $1.5 billion for both the three and six months ended June 30, 2007. The decrease in non-interest income in the second quarter of 2008 was primarily due to higher losses on investment activity, excluding foreign-currency related effects, which was partially offset by gains on our guarantee asset, increased income on our guarantee obligation and higher management and guarantee income. Increased losses on investment activity during the second quarter of 2008 were primarily due to the impact of the increase in interest rates on our investments classified as trading and security impairments recognized on available-for-sale non-agency mortgage-related securities backed by subprime and Alt-A and other loans. Our investments classified as trading securities included those securities for which we elected fair value accounting under SFAS 159. The election of SFAS 159 for these securities provides income statement recognition of the economic hedge they provide against changes in the fair value of our guarantee asset and our derivative portfolio resulting from movements in interest rates. Losses related to trading securities were partially offset by gains on our guarantee asset and our derivative portfolio during the second quarter of 2008. Income on our guarantee obligation was $769 million and $474 million for the three months ended June 30, 2008 and 2007, respectively and $1.9 billion and $904 million for the six months ended June 30, 2008 and 2007, respectively. Our amortization of income on our guarantee obligation has accelerated in the three and six months ended June 30, 2008 as compared to the same 2007 periods in order to match our economic release from risk on the pools of mortgage loans we guarantee. Management and guarantee income increased 28%, to $757 million for the three months ended June 30, 2008 from $591 million for the three months ended June 30, 2007. Management and guarantee income increased to $1.5 billion, for the six months ended June 30, 2008 from $1.2 billion for the six months ended June 30, 2007. This reflects increases in the average balance of our PCs and Structured Securities of 14% and 15% on an annualized basis for the three and six months ended June 30, 2008, respectively. The increase also reflects higher average total management and guarantee fee rates for the three and six months ended June 30, 2008 compared to the same 2007 periods. See CONSOLIDATED RESULTS OF OPERATIONS Non-Interest Income for further discussion of our non-interest income.

Our non-interest expenses for the three months ended June 30, 2008 and 2007 totaled $3.5 billion and $1.5 billion, respectively. Our non-interest expenses for the six months ended June 30, 2008 and 2007 totaled $5.6 billion and $2.7 billion, respectively. Credit-related expenses were $2.8 billion and $0.5 billion for the three months ended June 30, 2008 and 2007, respectively. Credit-related expenses were $4.3 billion and $0.7 billion for the six months ended June 30, 2008 and 2007, respectively. For the three and six months ended June 30, 2008, our provision for credit losses increased due to credit deterioration in our single-family credit guarantee portfolio, primarily due to increases in delinquency rates and higher severity of losses on a per-property basis. Credit deterioration has been largely driven by declines in home prices and regional economic conditions as well as the effect of a higher composition of nontraditional products in the mortgage origination market purchased prior to 2008. Nontraditional mortgage products, such as interest-only and Alt-A loans, made up 20% to 30% of our mortgage purchase volume during 2006 and 2007. Due to changes in underwriting practice and reduced originations in the market, these products made up approximately 7% to 10% of our mortgage purchase volume during the six months ended June 30, 2008. REO operations expense increased as a result of an increase in market-based write-downs of REO property due to the decline in home prices, coupled with higher volumes in REO inventory, particularly in the states of California, Florida, Arizona, Virginia and Nevada.

Non-interest expense, excluding credit-related expenses, for the three and six months ended June 30, 2008 totaled $743 million and $1.4 billion, compared to $1.1 billion and $2.0 billion for the three and six months ended June 30, 2007, respectively. The decline in non-interest expense, excluding credit-related expenses, was primarily due to the reductions in losses on certain credit guarantees and losses on loans purchased. Losses on certain credit guarantees decreased to $ and $15 million for the three and six months ended June 30, 2008, compared to $150 million and

$327 million for the three and six months ended June 30, 2007, due to the change in our method for determining the fair value of our newly-issued guarantee obligation upon adoption of SFAS 157 that we adopted effective January 1, 2008. Losses on loans purchased decreased to $120 million and $171 million for the three and six months ended June 30, 2008, compared to $264 million and $480 million for the three and six months ended June 30, 2007, respectively, due to changes in our operational practice of purchasing delinquent loans out of PC pools. See CONSOLIDATED RESULTS OF OPERATIONS Non-Interest Expense *Losses on Certain Credit Guarantees* and *Losses on Loans Purchased*, for additional information on the change in our operational practice. Administrative expenses totaled $404 million for the three months ended June 30, 2008, down from $442 million for the three months ended June 30, 2007. As a percentage of our average total mortgage portfolio, administrative expenses declined to 7.4 basis points for the three months ended June 30, 2008, from 9.2 basis points for the three months ended June 30, 2007. Administrative expenses totaled $801 million for the six months ended June 30, 2008, down from $845 million for the six months ended June 30, 2007. As a percentage of our average total mortgage portfolio,

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administrative expenses declined to 7.5 basis points for the six months ended June 30, 2008, from 8.9 basis points for the six months ended June 30, 2007.

For the three months ended June 30, 2008 and 2007, we recognized effective tax rates of 56% and 11%, respectively. For the six months ended June 30, 2008 and 2007, we recognized effective tax rates of 60% and (103)%, respectively. See NOTE 12: INCOME TAXES to our consolidated financial statements for additional information about how our effective tax rate is determined.

Segments

We manage our business through three reportable segments:

- Investments;
- Single-family Guarantee; and
- Multifamily.

Certain activities that are not part of a segment are included in the All Other category. We manage and evaluate the performance of the segments and All Other using a Segment Earnings approach. Segment Earnings differs significantly from, and should not be used as a substitute for, net income (loss) as determined in accordance with GAAP. There are important limitations to using Segment Earnings as a measure of our financial performance. Among them, our regulatory capital requirements are based on our GAAP results. Segment Earnings adjusts for the effects of certain gains and losses and mark-to-fair-value items which, depending on market circumstances, can significantly affect, positively or negatively, our GAAP results and which, in recent periods, have caused us to record GAAP net losses. GAAP net losses will adversely impact our regulatory capital, regardless of results reflected in Segment Earnings. For a summary and description of our financial performance on a segment basis, see CONSOLIDATED RESULTS OF OPERATIONS Segment Earnings and NOTE 16: SEGMENT REPORTING in the accompanying notes to our consolidated financial statements.

In managing our business, we present the operating performance of our segments using Segment Earnings. Segment Earnings present our results on an accrual basis as the cash flows from our segments are earned over time. The objective of Segment Earnings is to present our results in a manner more consistent with our business models. The business model for our investment activity is one where we generally buy and hold our investments in mortgage-related assets for the long term, fund our investments with debt and use derivatives to minimize interest rate risk and generate net interest income in line with our return on equity objectives. We believe it is meaningful to measure the performance of our investment business using long-term returns, not short-term value. The business model for our credit guarantee activity is one where we are a long-term guarantor in the conforming mortgage markets, manage credit risk and generate guarantee and credit fees, net of incurred credit losses. As a result of these business models, we believe that this accrual-based metric is a meaningful way to present our results as actual cash flows are realized, net of credit losses and impairments. We believe Segment Earnings provides us with a view of our financial results that is more consistent with our business objectives, which helps us better evaluate the performance of our business, both from period-to-period and over the longer term.

Table 1 presents Segment Earnings (loss) by segment and the All Other category and includes a reconciliation of Segment Earnings (loss) to net income (loss) prepared in accordance with GAAP.

Table 1 Reconciliation of Segment Earnings (Loss) to GAAP Net Income (Loss)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(in millions)			
Segment Earnings (loss) after taxes:				
Investments	$ 793	$ 571	$ 906	$ 1,085
Single-family Guarantee	(1,388)	129	(1,846)	353
Multifamily	118	84	216	209
All Other	144	(43)	140	(59)
Total Segment Earnings (loss), net of taxes	(333)	741	(584)	1,588
Reconciliation to GAAP net income (loss):				
Derivative- and foreign-currency denominated debt-related adjustments	527	(471)	(667)	(1,553)
Credit guarantee-related adjustments	1,818	831	1,644	329
Investment sales, debt retirements and fair value-related adjustments	(3,096)	(379)	(1,571)	(310)
Fully taxable-equivalent adjustments	(105)	(97)	(215)	(190)
Total pre-tax adjustments	(856)	(116)	(809)	(1,724)
Tax-related adjustments	368	104	421	732
Total reconciling items, net of taxes	(488)	(12)	(388)	(992)
GAAP net income (loss)	$ (821)	$ 729	$ (972)	$ 596

Investments Segment

Our Investments segment is responsible for our investment activity in mortgages and mortgage-related securities, other investments, debt financing and managing our interest-rate risk, liquidity and capital positions. We invest principally in mortgage-related securities and single-family mortgage loans through our mortgage-related investment portfolio.

We seek to generate attractive returns on our portfolio of mortgage-related investments while maintaining a disciplined approach to interest-rate risk and capital management. We seek to accomplish this objective through opportunistic purchases, sales and restructurings of mortgage assets and repurchases of liabilities. Although we are primarily a buy-and-hold investor in mortgage assets, we may sell assets to reduce risk, to respond to capital constraints, to provide liquidity or to structure certain transactions in order to improve our returns. We estimate our expected investment returns using an option-adjusted spread, or OAS, approach. Our Investments segment activities may also include the purchase of mortgages and mortgage-related securities with less attractive investment returns and with incremental risk in order to achieve our affordable housing goals and subgoals. Additionally, we maintain a cash and non-mortgage-related securities investment portfolio in this segment to help manage our liquidity needs.

Investments segment performance highlights for the three and six months ended June 30, 2008:

Segment Earnings increased 39% to $793 million in the second quarter of 2008 versus $571 million in the second quarter of 2007. For the six months ended June 30, 2008, Segment Earnings decreased 17% to $906 million from $1.1 billion during the six months ended June 30, 2007.

Segment Earnings net interest yield increased 23 basis points in the second quarter of 2008, as compared to the second quarter of 2007, due to the purchase of fixed-rate assets at significantly wider spreads relative to our funding costs and the amortization of gains on certain futures positions that matured in March 2008. Segment Earnings net interest yield decreased 3 basis points in the six months ended June 30, 2008 compared to the six months ended June 30, 2007 due to spread compression between our floating rate assets and liabilities during the first three months of 2008, which was mostly offset by wider spreads in the second quarter of 2008.

During the second quarter of 2008, we recognized security impairments in Segment Earnings of $142 million associated with anticipated future principal credit losses on our non-agency mortgage-related securities.

Capital constraints and OAS levels that were not compelling early in the first quarter of 2008 became less restrictive in the latter part of the first quarter and through the second quarter. Starting in March and continuing through the second quarter of 2008, our net mortgage purchase commitments for the mortgage-related investment portfolio were substantially higher than earlier in 2008 in response to substantially wider OAS. The unpaid principal balance of our mortgage-related investment portfolio increased 9.8% to $728 billion at June 30, 2008 compared to $663 billion at December 31, 2007. Agency securities comprised approximately 67% of the unpaid principal balance of the mortgage-related investment portfolio at June 30, 2008 versus 61% at December 31, 2007.

In addition during March 2008, OFHEO reduced our mandatory target capital surplus to 20% allowing us to take advantage of favorable investment opportunities. The ability to take advantage of favorable investment opportunities not only helped to serve our mission, but also benefited our customers and the secondary mortgage market during the second quarter of 2008. Also, effective March 1, 2008, we were no longer subject to the voluntary growth limit of 2% annually on our retained portfolio.

We continued to be able to issue debt securities at attractive levels during the second quarter of 2008.

Single-family Guarantee Segment

In our Single-family Guarantee segment, we securitize substantially all of the newly or recently originated single-family mortgages we have purchased and issue mortgage-related securities called PCs that can be sold to investors or held by us in our Investments segment. We guarantee the payment of principal and interest on our single-family PCs, including those held in our retained portfolio, in exchange for management and guarantee fees, which are paid on a monthly basis as a percentage of the underlying unpaid principal balance of the loans, and initial upfront cash payments referred to as credit or delivery fees. Earnings for this segment consist of management and guarantee fee revenues, including amortization of upfront payments, and trust management fees, less the related credit costs (*i.e.*, provision for credit losses) and operating expenses. Also included is the interest earned on assets held in the Investments segment related to single-family guarantee activities, net of allocated funding costs.

Single-family Guarantee segment performance highlights for the three and six months ended June 30, 2008 and 2007:

Segment Earnings (loss) decreased to $(1.4) billion for the three months ended June 30, 2008 compared to earnings of $129 million for the three months ended June 30, 2007. Segment Earnings (loss) decreased to $(1.8) billion for the six months ended June 30, 2008 compared to earnings of $353 million for the six months ended June 30, 2007.

Segment Earnings provision for credit losses for the Single-family Guarantee segment increased to $2.6 billion for the three months ended June 30, 2008 from $469 million for the three months ended June 30, 2007. Segment Earnings provision for credit losses for the Single-family Guarantee segment increased to $4.0 billion for the six months ended June 30, 2008 from $758 million for the six months ended June 30, 2007.

Realized single-family credit losses for the three months ended June 30, 2008 were 18.1 basis points of the average single-family credit guarantee portfolio, compared to 2.0 basis points for the three months ended June 30, 2007. Realized single-family credit losses for the six months ended June 30, 2008 were 15.1 basis points compared to 1.8 basis points for the six months ended June 30, 2007.

We implemented several delivery fee increases that were effective at varying dates between March and June 2008, or as our customers contracts permitted. These increases include an additional 25 basis point fee assessed on all loans issued through flow-business channels, as well as higher or new delivery fees for certain mortgage products and for mortgages deemed to be higher-risk based primarily on property type, loan purpose, loan-to-value, or LTV ratio and/or borrower credit scores. We also implemented several changes in our underwriting and eligibility criteria in early 2008 to reduce our credit risk, including requiring our seller/servicers to deliver loans with larger down payments and higher credit scores, and limiting our acquisition of certain higher-risk loan products, such as Alt-A loans.

The single-family credit guarantee portfolio increased by 9% and 15% on an annualized basis for the three months ended June 30, 2008 and 2007, respectively.

Average rates of Segment Earnings management and guarantee fee income for the Single-family Guarantee segment increased to 18.7 basis points for the three months ended June 30, 2008 compared to 17.9 basis points for the three months ended June 30, 2007. Average rates of Segment Earnings management and guarantee fee income for the Single-family Guarantee segment increased to 19.6 basis points for the six months ended June 30, 2008 compared to 17.9 basis points for the six months ended June 30, 2007.

Multifamily Segment

Our Multifamily segment activities include purchases of multifamily mortgages for our retained portfolio and guarantees of payments of principal and interest on multifamily mortgage-related securities and mortgages underlying multifamily housing revenue bonds. The assets of the Multifamily segment include mortgages that finance multifamily rental apartments. Our Multifamily segment also includes certain equity investments in various limited partnerships that sponsor low- and moderate-income multifamily rental apartments, which benefit from low-income housing tax credits, or LIHTC. These activities support our mission to supply financing for affordable rental housing. Also included is the interest earned on assets held in our Investments segment related to multifamily guarantee activities, net of allocated funding costs.

Multifamily segment performance highlights for the three and six months ended June 30, 2008 and 2007:

Segment Earnings increased 40% to $118 million for the three months ended June 30, 2008 versus $84 million for the three months ended June 30, 2007. Segment Earnings increased 3% to $216 million for the six months ended June 30, 2008 versus $209 million for the six months ended June 30, 2007.

Segment Earnings net interest income was $98 million for the three months ended June 30, 2008, an increase of $4 million versus the three months ended June 30, 2007 as a result of an increase in interest income on mortgage loans due to higher average balances, partially offset by a decrease in prepayment, or yield maintenance, fee income. Segment Earnings net interest income was $173 million for the six months ended June 30, 2008, a decline of $44 million versus the six months ended June 30, 2007.

Mortgage purchases into our multifamily loan portfolio increased approximately 74% for the three months ended June 30, 2008 to $4.2 billion from $2.4 billion for the three months ended June 30, 2007. Mortgage purchases into our multifamily loan portfolio increased approximately 49% for the six months ended June 30, 2008 to $8.3 billion from $5.5 billion for the six months ended June 30, 2007.

Unpaid principal balance of our multifamily mortgage loan portfolio increased to $63.8 billion at June 30, 2008 from $57.6 billion at December 31, 2007 as market fundamentals continued to provide opportunities to purchase loans to be held in our portfolio.

Segment Earnings provision for credit losses for the Multifamily segment totaled $7 million and $16 million for the three and six months ended June 30, 2008, respectively. Segment Earnings provision for credit losses for the Multifamily segment totaled $1 million and $4 million for the three and six months ended June 30, 2007, respectively.

Capital Management

Our primary objective in managing capital is preserving our safety and soundness and having sufficient capital to support our business and mission. We make investment decisions while considering our capital levels. OFHEO monitors our capital adequacy using several capital standards. Beginning in January 2004, OFHEO directed us to maintain a 30% mandatory target capital surplus above our statutory minimum capital requirement. On March 19, 2008, OFHEO reduced our mandatory target capital surplus to 20% above our statutory minimum capital requirement, and in return we announced that we would begin the process to raise capital and maintain overall capital levels well in excess of requirements while the mortgage markets recover. At June 30, 2008, our estimated regulatory core capital was $37.1 billion, which is an estimated $8.4 billion in excess of our statutory minimum capital requirement and $2.7 billion in excess of the 20% mandatory target capital surplus.

On May 14, 2008, we announced our commitment to raise $5.5 billion of new core capital through one or more offerings, which will likely include both common or common equivalent and preferred securities. The timing, amount and mix of securities to be offered will depend on a variety of factors, including prevailing market conditions and approval by our board of directors. OFHEO has informed us that, upon completion of these offerings, our mandatory target capital surplus will be reduced from 20% to 15%. OFHEO has also informed us that it intends a further reduction of our mandatory target capital surplus from 15% to 10% upon the combination of completion of our SEC registration process, which was completed on July 18, 2008, our completion of the remaining Consent Order requirement (*i.e.*, the separation of the positions of Chairman and Chief Executive Officer), our continued commitment to maintain capital well above OFHEO s regulatory requirement and no material adverse changes to ongoing regulatory compliance.

The sharp decline in the housing market and volatility in financial markets continue to adversely affect our capital, including our ability to manage to our regulatory capital requirements and the 20% mandatory target capital surplus. Factors that could adversely affect the adequacy of our capital in future periods include our ability to execute capital raising transactions; GAAP net losses; continued declines in home prices; increases in our credit and interest-rate risk profiles; adverse changes in interest-rates, the yield curve or implied volatility; adverse OAS changes; impairments of non-agency mortgage-related securities; downgrades of non-agency mortgage-related securities (with respect to regulatory risk-based capital); counterparty downgrades; legislative or regulatory actions that increase capital requirements or changes in accounting practices or standards.