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Freddie Mac Q4 2007 Earnings Call Transcript

Question-and-Answer Session

Operator

And once again ladies and gentlemen if you would like to ask a question please press the star then one on your touchtone phone, you'll hear a tone indicating you've been placed in queue. If your question gets answered or you wish to remove yourself from the queue please press the pound key. And we'll first go to the line of Kenneth Posner with Morgan Stanley, please go ahead.

Kenneth Posner – Morgan Stanley

Good afternoon and thank you for the disclosures and the adjusted operating income, that's all great stuff, it'll take us a while to understand. I have a question about this pesky fair value number which did fall substantially, particularly on a common equity basis for Freddie Mac in the quarter and I wondered if you'd just comment on how you're valuing the general or the guaranty obligation? If I've done the math right, maybe I didn't, you're valuing the guaranty obligation at 1.5% of the credit book and your competitor Fannie Mae seems to be valuing it, again if I did the math properly at 75 basis points. How can that be and are these the right numbers?

Patty Cook

Ken thanks for the question. You know I can't speak to how our competitor values their GO but I can try and be as transparent as possible as to how we do it. And as you noticed in my prepared remarks, we come at that expectation of the present value of future expected default costs in $12-$15 billion range by looking at a median house price decline peak to trough of about 15%, we look at a Monte Carlo simulation around that in terms of trying to estimate what default probabilities would be on that portfolio. And that's sort of the interesting statistic I think you need to focus on. It suggests about a 3.5% default rate with 25% severity. So you in your own mind need to decide whether or not you think that's reasonable.

What we do when we go to the market is we go beyond just an assessment of expected default cost with maybe a modest risk premium and actually capture the risk premiums that are in the marketplace in terms of the wider spread on mortgages and mortgage related assets as we ask dealers for a price, for a spread. So the difference between what's in our fair value balance sheet and our estimate is that different in risk premium, which is as I said in my comments we would expect to earn back over time. One other comment I would make, the other thing that's significant is to look at the delinquencies. You know currently we have delinquencies of 65 basis points. So again I think you need to look at 65 basis points of delinquencies and you know an expectation of 3.5% defaults get you to the $12-$15 billion then I think you can put the GO that's on the fair value balance sheet in context.

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