

July 14, 2008

In light of mounting financial pressure against Fannie Mae and Freddie Mac, and a quick series of federal steps this weekend aimed at supporting the two government sponsored mortgage giants, SVB Asset Management wants to provide our clients a clearer perspective of the situation, especially with regard to the general safety of agency investments.

Q: Will these firms fail?

A: No. We expect, and are already seeing, that the U.S. government will provide clear and sweeping direct support to Fannie Mae and Freddie Mac to avoid such an outcome. This applies to both their current business strength as well as the support of their outstanding debt and their numerous counterparty exposures. The consequences of not supporting these firms and their trillions in debt would impose unacceptable and unprecedented systematic risk not only to the U.S. but globally for the foreseeable future.

Q: Does SVB Asset Management foresee Fannie Mae and Freddie Mac bonds at risk of failure, illiquidity or principal loss?

A: No. The importance of the viability of these two entities is difficult to underestimate. Together they either guarantee or retain in portfolio about \$5.2 trillion, which represents 43 percent of the approximately \$12.1 trillion of total U.S. residential mortgage debt. Their full functionality remains an essential part of government efforts to stabilize the mortgage markets as indicated by the Treasury and the Federal Reserve. The original mission of these two firms was to provide liquidity and readily available financing to the mortgage market and that mandate has become an increasingly critical part of the recovery of the U.S. housing market and the economy as a whole.

Q: What government steps have been taken to ensure their continued liquidity?

A: Fannie Mae and Freddie Mac's collective size and their importance to the U.S. economy are due in large part to their status as Government Sponsored Entities (GSEs). The White House, the U.S. Treasury and the Federal Reserve were active this weekend in clarifying what steps are being taken to support them.

Actions by the White House/U.S. Treasury: After providing strong verbal support for both firms throughout the week, on Sunday Treasury Secretary Paulson announced plans to seek approval from Congress for a increase in the Treasury line of credit for the two companies and temporary authority to buy equity in either company "if needed" to ensure their access to capital. Estimates of the size of the credit ranged as high as \$300 billion. The plan also gives the Federal Reserve some oversight of the GSEs' future capital requirements and business practices. Congress is expected to vote on the plan as early as this week.

Actions by the Federal Reserve: The Fed's Board of Governors assembled and voted Sunday to allow direct lending to Fannie Mae and Freddie Mac via the New York Federal Reserve. The move effectively gives the firms access to the Fed's discount window and provides a guaranteed backstop in case either firm were to face short-term funding difficulties.

Q: What caused this to happen?

A: The recent massive sell-off was at least partly driven by analyst reports claiming that a proposed FASB rule requiring banks and GSEs to bring off balance sheet exposures onto the balance sheets would significantly erode their current capital levels and their ability to raise capital despite significant uncertainty around the time frame of such an implementation, if it occurs at all. This argument persisted in equity markets throughout the week, exacerbated by former Fed president William Poole's claim that Freddie Mac was indeed 'insolvent.'

Their difficulties were also heightened by their rapid growth amid lingering concerns that they have too much risk and leverage underpinned by mortgage capital. The credit crisis has abruptly shuttered or significantly slowed the residential lending activity that was booming less than two years ago. In its place, the U.S. government, through Fannie Mae and Freddie Mac has become in a real sense the lender of last resort. Despite no sign of mortgage market stability, the GSEs' market share of new lending business has grown to the point that they now represent the largest share of new mortgage originations.

Q: Are the risks to these firms overblown?

A: Not at all. Typically, client investment policies have no limit on the amount of GSE/Agency exposure they allow in their portfolios. In April 2008, SVB Asset Management took the unusual step of limiting exposure to Fannie Mae or Freddie Mac to no more than 5 percent of our total investment portfolio. By comparison the maximum exposure SAM allocates to corporate issuers is 3 percent of the total portfolio. Today our investment in these two firms is well below 1 percent of our total portfolio. Our rationale then is the same as it is today. We continue to see a remarkably high level of volatility in their primary market and we expect this to continue.

Going forward, we expect that the credit costs for both GSEs to be high in the next few years, well above their historical costs. This can be offset only if the GSEs can continue to grow their revenue. To their credit, both Fannie and Freddie have large and relatively liquid portfolios, open access to debt markets and over \$1.5 trillion in unpledged assets which they can use to support their credit profile. Nevertheless, both GSEs remain highly leveraged and as the largest participants in the mortgage markets with balance sheets under stress from the legacy non agency investments, it is critical that they continue to shore up their capital base to strengthen their financial position and restore investor confidence.

As always, we encourage you to contact us directly with any questions you may have.

Sincerely,

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