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Washington, D.C. 20220

RE: Public Input on Reform of the Housing Finance System, Docket ID:HUD-2010-0029

To Whom It May Concern:

In our view the GSEs play a critical role in U.S. mortgage finance, creating a liquid market for long dated mortgages preferred by consumers, but difficult for banks to keep on their balance sheets. However, we recognize that the GSEs also played a critical role in the excessive leverage in U.S. housing that precipitated the downturn. As a result, we believe that GSE reform is necessary to ensure the federal policy does not exacerbate boom and bust cycles in the future.

We expect a full housing recovery to take a number of years and that further federal support for the GSEs is needed. We published our recommendations and outlook for the future of the GSEs in October 2009 in a report entitled "*An Augean Task: A Government Exit Strategy to Recapitalize Fannie Mae and Freddie Mac*". We believe that the plan we presented achieves three critical objectives of reform that should be central to any plan put forward:

- Recapitalization of the GSEs with private sector funding in order to achieve a stable system with market discipline, including "skin in the game" by private mortgage originators.
- Phasing out of the GSEs portfolio retention activities except those that support the guarantees of conforming mortgages, including setting up a "Bad GSE/Good GSE" structure to aid in the transition.
- Continuity of the mortgage securitization process during reform to ensure that there is no major disruption in mortgage availability, including maintaining the TBA market¹ (the forward market for Agency MBS that allows banks to offer the product to consumers)

¹ The "to-be-announced" or TBA market is the most liquid part of the Agency MBS Market. This market allows mortgage originators to hedge their mortgage origination pipelines by selling loans forward and as such is crucial to a well functioning primary mortgage market. The TBA market is what allows mortgage originators to offer consumers a specified mortgage rate 30-60 days before a loan closes.

We believe that one of the most important issues related to Fannie Mae and Freddie Mac is capital. Unless the companies are shut down and their portfolios are run off, the companies or any successor entities will need capital. We don't believe that privatization to public common share ownership, even if it were politically feasible, is a viable option. The primary benefits that Fannie Mae and Freddie Mac pass on to borrowers are derived from their GSE status and their resulting ability to fund their portfolios and issue MBS at very close to risk free rates. There is no franchise that can be privatized.

The entities currently operate with no capital and the Treasury Department's investment in the form of senior preferred shares, which stood at \$144.9 billion at the end of 1Q10, is intended to keep the entities from having negative net worth. We estimate that this debt will continue to increase at least through the end of 2010 and likely longer. Since the GSEs have to make a 10% dividend payment on this debt, we cannot envision a scenario where the GSEs are able to make enough money to repay this debt.

As a result, we believe that the best option for the GSEs is to separate the existing books of business into old bad GSEs that are put into runoff and new good GSEs that are run as cooperatives of bank mortgage lenders in a structure similar to what exists with the Federal Home Loan Bank System (FHLBs). This is not a traditional good bank/bad bank structure because the bad bank will not have any equity. The bad bank will just be a vehicle that is used to run off the legacy portfolios.

Our recommendation is for a very meaningful increase in minimum capital levels to 5% for mortgages for which the GSEs retain credit risk in the "Good GSEs". We also endorse a wind-down of the retained portfolio, consistent with the current preferred share purchase agreement (PSPA) that was agreed to by the GSEs when they were put into conservatorship. Since the GSEs would be required to shrink their retained portfolios they would not be able to benefit from the fact that they would not have any incremental capital requirement for assets held in their retained portfolios.

As of March 2010, residential mortgage debt outstanding totaled approximately \$10.75 trillion according to the Federal Reserve Flow of Funds data. The GSEs currently manage the credit risk for approximately 47.4% of the market given their \$5.1 trillion portfolio of Agency MBS and whole loans. Given the GSEs' current capital position of zero (including the government's investment), we estimate that the GSEs' current books of business will require roughly \$250 billion of incremental capital if they adopt a 5% minimum capital requirement. Since it would be very difficult to raise this in the public markets, we suggest that GSEs be restructured using the Federal Home Loan Bank (FHLB) system as a template. Under this scenario, any bank that originates an agency conforming loan and wishes to sell the loan to the GSEs would be required to retain 5% of the loan balance as an equity investment in the GSEs. Thus, the new agencies would be recapitalized at a solid 5% level and we believe that this capital level would provide a significant buffer against potential losses. Like the FHLB system, the "New GSEs" would have boards of directors representing the ownership of the capital in the companies.

If the capital levels we propose existed before the downturn, the GSEs' would have gone into the crisis with an additional \$200 billion in capital, which suggests that the companies would have a current capital position of positive \$54 billion. Our analysis

suggests that this level of capital would have been sufficient to weather the downturn without the GSEs' capital levels falling below zero.

We believe that our recapitalization plan would be acceptable to the banks for three reasons:

- 1) Mortgage banks will continue to generate gain-on-sale income and by participating as owners they would also receive returns in the form of dividends;
- 2) Banks can lever their investment, so the capital contribution could be 1/20th of the dollar amount of the investment, assuming a 100% risk weight and a 5% tangible capital ratio. The leverage could be higher if we used a 20% risk weight which is the risk weight for FHLB stock; and
- 3) The new GSEs would have no retained portfolios. Historically, the banks resented the aggressive portfolio growth of the GSEs.

While our much higher proposed capital levels (5% versus 45 bp) would result in the profitability of the guarantee business falling sharply, this is not meaningful since there will be no private shareholders of the new GSEs. Further, we believe that the 5% capital requirement by the originators would provide "skin in the game" giving incentives to the originators to ensure high credit quality standards for GSE mortgages.

We believe that the leverage that the banks can achieve on their investment is key to their acceptance of this plan since it results in very manageable capital outlays for the banks. For example, the largest seller to GSEs is Wells Fargo. The company sold \$281 billion to the GSEs in 2009 and assuming a 30% decline in the market as a whole, this number should be about \$200 billion in 2010. The 5% capital requirement would mean a \$10 billion investment of which \$500 million would have to be Tier 1 equity (we recognize that bank capital requirements are under review and that this level could increase). For the industry as a whole, the equivalent numbers for 2010 would be \$43 billion of which \$2.2 billion would have to be Tier 1 equity. This would represent roughly 25 bp of total bank capital.

Also, once most of the conforming market has moved over to the new GSEs then the incremental capital commitments would essentially be equal to growth in mortgage debt outstanding so it should be very limited. Our estimates suggest that it should take about 5-7 years to transfer most of the mortgage market over to the new GSEs. At that point, the new GSEs will have about \$250 billion of capital. This level of capital would also allow the GSEs to maintain moderate investment portfolios necessary for the guarantee business with little or no leverage. We believe that GSEs would need to hold some loans and securities as part of their guarantee business in order to facilitate securitization or improve liquidity in some markets.

Separately, we acknowledge that non-banks would be at a disadvantage under this system since they are not able to assume leverage in the same manner as banks. While the vast majority of mortgage originators are banks, we believe that non-banks should be given special status in order to ensure that they are able to compete effectively with banks in the mortgage origination market. One option is a lower capital requirement for non-banks but

with restrictions to ensure that banks don't use non-bank subsidiaries to originate their mortgages.

The capital at the new GSEs will effectively be permanent capital although it can be redeemed when mortgages pay down. We think that this does not create a material risk for the new GSEs. While they will have to hold significant portions of their capital in liquid assets to meet paydowns, any capital reduction would be temporary. The only way paydowns would be permanent is if mortgage debt outstanding contracts sharply and that has not happened even in this downturn.

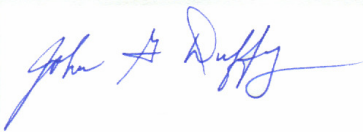
We acknowledge that the FHLB system has not come through this downturn untarnished. However, we want to highlight that the FHLB system losses have almost entirely come from direct investments in mortgage securities, which was not part of their core mission of making collateralized loans to depositories.

While our current proposal does not address this in detail, there also needs to be further restrictions on what ends up in the GSEs guarantee portfolio and retained portfolio. When we think about what happened to the GSEs, their size was not the main driver of problems at either the retained portfolio or the guarantee portfolio. In both cases the problem was a divergence from the core mission combined with inadequate capital. Our plan addresses the capital issue but much tighter regulation is also a necessary part of the solution.

We acknowledge that if these proposals are in place the mortgage market would look different. 30-year fixed-rate mortgage rates would be higher but we think more borrowers would move towards adjustable rate hybrid ARMs with shorter term resets of 5-7 years and rates here could be attractive since private investors should be interested in investing in these shorter duration assts. The borrower would clearly bear more interest rate risk but we think that's a reasonable price to pay for more financial stability.

Finally, we believe that given the government's role in the market supporting the GSEs during this crisis, the implicit guarantee has effectively become explicit so the question of whether the guarantee should be implicit or explicit is moot. Further, since our proposal greatly reduces the need for the successor entities to issue debentures, an explicit guarantee by the government would have a budgetary impact only to the extent that the companies' capital and revenues are inadequate for covering potential losses. This is similar to the current accounting for FHA. Given this, we believe that the GSE successor entities should be set up to issue MBS with an explicit guarantee.

Sincerely yours,



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