

A Simple Solution to GSE Reform: A Fourth Amendment

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Mr. Richard Shelby
Senate Banking Committee
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510

March 29, 2016

Re: A Simple Solution to GSE Reform

Dear Mr. Shelby,

In January, 2015, I was a part of an activist investor group meeting in the Senate offices of David Perdue to discuss the current status and recent history involving Fannie Mae and Freddie Mac, the two Government Sponsored Enterprises (GSE's) which were placed into conservatorship in September, 2008.¹

Any person who reviews the future path of GSE Reform needs to ask two primary questions before enacting any meaningful reform alternatives.

THE FOUR-SQUARE ALTERNATIVE:

TWO BINARY CHOICES:		DOES THE US GOVERNMENT CLOSE THE GSE'S (FANNIE MAE AND / OR FREDDIE MAC)?	
		Yes	No
IS THE US GOVERNMENT INVOLVED WITH THE US MORTGAGE MARKET IN THE FUTURE?	Yes	Create a new mortgage issuance entity	Allow the GSE's to operate with revised risk modification and loan guidelines
	No	Wind down Fannie Mae and Freddie Mac (greater than \$5 Trillion Portfolio)	Release the GSE's

As Senator David Perdue of Georgia has been successful in both reorganizing and saving jobs in the private sector at Dollar General before his arrival into the US Congress, a simple solution approach to GSE Reform may fit promotion from his office as well as all of the House Financial Services Committee and the Senate Banking Committee. This promotion would help save and direct the future of these two companies.

¹ A brief history review of the Fannie Mae and Freddie Mac situation can be found online: http://en.wikipedia.org/wiki/Federal_takeover_of_Fannie_Mae_and_Freddie_Mac

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In this letter, I outline a path for GSE reform which may provide a simple but elegant solution offering a beneficial future for many interested parties: employees of Fannie Mae and Freddie Mac, US Taxpayers, US Treasury, FHFA and investors who have provided capital to purchase fixed income mortgages, preferred shares and common shares in the GSE's. I believe it is in the best interest of many of these involved groups to put this last chapter of the GSE conservatorship behind us. Listed below are steps which could be taken to remove a significant amount of the difficult to maneuver political roadblocks and litigation hurdles related to GSE reform.

It is my hope the reader concludes from the provided information that releasing the GSE's from conservatorship and continuing the operations of GSE's with revised mortgage issuance governance, an upwardly adjusted capital cushion from private capital and with minimal US Government involvement is the most prudent and economically viable long-term path for both the United States housing market and the United States taxpayer. This assessment comes by digging deeper into the above four square alternative and reviewing the financial positions of the two entities.

Let's look at these above two questions individually and then frame them in the four square alternative:

Question 1: Is the US Government involved with the US Mortgage Market in the future?

Potential Answer: Yes or No

If You Answer the Above Question 1 with 'No':

If you answer this question as 'no', then the U.S. Treasury needs to end the loan backstop (the third amendment) enacted between the US Treasury, the FHFA and with the GSE's, revoke the charters of both Fannie Mae and Freddie Mac and formally declare that there is no 'implicit guarantee to the U.S. Mortgage Market', formally ending the U.S. Government involvement.

The result of this action will most likely result in the following chain of events:

- a. The charters for Fannie Mae and Freddie Mac need to be revoked;
- b. Fannie Mae and Freddie Mac will need to be wound down with their operations converted from a conservatorship to a receivership;
- c. Approximately twelve thousand (12,000) jobs will be lost at Fannie Mae and Freddie Mac;
- d. New regulations will need to be enacted to oversee private mortgage issuers;
- e. The cost for mortgage borrowing through the private sector will likely rise;
- f. The opportunity for many homeowners to obtain a thirty year mortgage loan will most likely evaporate;

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- g. The prices and secondary market for Fannie Mae and Freddie Mac mortgage securities will fall in both value and liquidity resulting in an inadvertent tax on the public and private institutions that hold these securities;
- h. A complete loss of value of US Treasury eighty percent (80%) equity ownership in GSE's may occur;
- i. The US Government will also lose the potential for any tax receipts related to private ownership and related taxable gains in the GSE's.
- j. Litigation involving the US Treasury and FHFA will continue on behalf of private equity investors in the two GSE's;
- k. The US Government will receive lessened tax receipts from lowered housing values.

If You Answer the Above Question 1 with 'Yes':

If you answer 1 question with 'Yes', the following are some of the benefits that the U.S. Government may receive from an involvement in the US Mortgage Market:

- a. Allow individuals in the United States to more easily obtain the goal of homeownership through both easier access to mortgages and lowered borrowing rates;
- b. Continuing the jobs and employment of approximately twelve thousand (12,000) individuals currently employed at the GSE's;
- c. Providing stability to the housing market;
- d. The thirty year mortgage alternative may continue;
- e. The US Government will continue to provide affordable housing assistance to various groups and interests across the nation which will assist with creating higher tax receipts from relatively improving housing values;
- f. Numerous other considerations including obtaining value to the US Treasury from the eighty percent (80%) equity ownership in GSE's.
- g. The current value of the US Treasury's eighty percent (80%) ownership stake in the GSE's is estimated to be greater than one hundred fifty (\$150) billion dollars.
- h. The US Government will retain the potential tax receipts related to private ownership and related taxable gains in the GSE's;
- i. The US Government will receive greater revenue in the future earnings and tax revenues derived from higher property values across the United States.

Question 1 Review:

Separate groups with different interests will answer question 1 in varying ways. The answer does not simply boil down to what position the U.S. Government should take in assisting with homeownership. The answer must take a look at the dynamic role a government assumes when considering all the benefits from a receiver of taxes based on property values. Once again, if your view is that the U.S. Government should not be involved, the path for the U.S. Government is simple: 1. exit the mortgage market by declaring the loan from the U.S. Treasury to the GSE's as paid off; 2. revoke the charter of Fannie Mae and Freddie Mac; and 3. close down these entities.

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If you do not share this drastic view for GSE closure, then you must look at how the U.S. Government should be involved in the U.S. Mortgage Market (as it has been for over eighty years).²

I believe in this respect, when considering the financial, political and litigation alternatives, the best answer is that the U.S. Government should continue to be involved in the U.S. Mortgage Market.³

Whether you answer question 1 with a ‘Yes’ or ‘No’, an obvious question raised by answering the above question with ‘Yes’, is how much capital is needed to backstop a mortgage securities market that is greater than five trillion dollars?⁴

A Further Question of Capital Risk / Exposure:

The U.S. Government has a choice related to this above question of continued involvement in the US Housing Market. The US Government can either assume the capital risk and act as a guarantor to the U.S. housing mortgage market or it can raise additional private capital through equity, bond, or preferred stock to create a capital buffer of private ownership in either a newly chartered entity or the ongoing operations of Fannie Mae and Freddie Mac to reduce the need for additional capital requirements.

Capital Buffer Required:⁵

Size of Mortgage Market	Capital Cushion %	Capital Amount (private capital)
5 trillion	10%	\$500 Billion
5 trillion	5%	\$250 Billion
5 trillion	3%	\$150 Billion

How much capital is needed as support a greater than five trillion dollar mortgage market?⁶

Whatever your view on how much capital is needed to backstop a greater than five trillion dollar mortgage market, when addressing the capital needs of this mortgage market, there arises one major sticking point, ‘Where this capital will come from?’ Furthermore, the important question also raised is ‘whether it is easier to raise money for a new venture or for an established venture?’

² Replacing Fannie Mae and Freddie Mac Is A Fix That Has Nothing To Do With The Problem, Mark Greene, <http://www.forbes.com/sites/moneybuilder/2013/08/28/replacing-fannie-mae-and-freddie-mac-is-a-fix-that-has-nothing-to-do-with-the-problem/>

³ ‘Fannie and Freddie Must Not Die’: from CNBC, Richard Bove - <http://www.cnbc.com/id/101522658>

⁴ The view from the US Treasury is 3-4%: <http://www.housingwire.com/articles/33740-leaked-treasury-memo-on-fannie-freddie-fuels-fire-for-sweep-critics>

⁵ http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2015_DFAST_Severely-Adverse-Scenario.pdf

⁶ <http://www.housingwire.com/articles/33740-leaked-treasury-memo-on-fannie-freddie-fuels-fire-for-sweep-critics>

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Current Status:

Fannie Mae - owned by private shareholders

Number of years in operation / date of inception: 84 years / 1931

Freddie Mac – owned by private shareholders

Number of years in operation / date of inception: 34 years / 1971

Answer: I hope we would all agree that it is easier to raise large amounts of funds from two established companies with many years of experience, established credit ratings and workforces that are in place, rather than attempt to raise money for a new venture which does not have a greater than eighty year track record.⁷

Unless the U.S. Government wants to provide a permanent capital cushion for the U.S. Housing Market in a range of \$150 Billion to \$500 Billion dollars, capital needs to be provided for either a newly chartered entity or the ongoing operations of the GSE's. New capital will need to be raised from private investors in order to obtain this capital cushion.

Historical Performance:⁸

According to the Annual Report to Congress, filed by the Federal Housing Finance Agency, over a span of 37 years, from 1971 through 2007, Fannie's average annual loss rate on its mortgage book was about four basis points. Losses were disproportionately worse during the crisis years, 2008 through 2011, when Fannie's average annual loss rate was 52 basis points. Freddie Mac's results are comparable.

By way of contrast, during the 1991–2007 period, commercial banks' average annual loss rate on single family mortgages was about 15 basis points. During the 2008-2011 period, annual losses were 184 basis points.

Or take a look at the FHFA study that compares, on an apples-to-apples basis, GSEs loan originations with those for private label securitizations. The study segments loans four ways, by ARMs-versus-fixed-rate, as well as by vintage, by FICO score and by loan-to-value ratio. In almost every one of 1800 different comparisons covering years 2001 through 2008, GSE loan performance was exponentially better. On average, GSE fixed-rate loans performed four times better, and GSE ARMs performed five times better.

Unless the U.S. Government wants to provide a permanent capital cushion for the U.S. Housing Market in a range of \$150 Billion to \$500 Billion dollars, capital needs to be provided for either a newly chartered entity or the ongoing operations of the GSE's. New capital will need to be raised from private investors in order to obtain this capital cushion.

⁷ Additional Note: Standard & Poor's recently completed the following press release titled: "Why The Status Quo Is Likely To Continue For Fannie Mae And Freddie Mac."⁷ Furthermore, Moody's and Fitch currently and in the past have provided ratings to the securities issued by Fannie Mae and Freddie Mac.

⁸ From http://en.wikipedia.org/wiki/Federal_takeover_of_Fannie_Mae_and_Freddie_Mac

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The US Treasury Advocates Accessing Private Capital to Buffer Risk for the GSE's in the Future⁹

'Allowing the GSE's to exit conservatorship within the existing framework that includes their flawed charters, conflicting missions, and virtual monopolistic access to a government support through the PSPAs exposes taxpayers to great risk and is irresponsible. As we have said repeatedly, the only way to responsibly end the conservatorship of the GSE's is through legislation that puts in place a sustainable housing finance system with private capital at risk ahead of taxpayers, while preserving access to mortgage credit during severe downturns.'

QUESTION 2: Does the US Government close the GSE's (Fannie Mae and / or Freddie Mac)?

If You Answer the Above Question 2 with 'Yes':

1. Revoke the charter of Fannie Mae and Freddie Mac;
2. Declare the US Government loan to the GSE's as paid off;
3. Layoff thousands and thousands of employees at both Fannie Mae and Freddie Mac;
4. Allow the GSE's to wind down and close;
5. Regulate the future expansion of the private mortgage issuance marketplace which will arise for home ownership.

Positives:

1. The US Government will have no formal financial involvement or implicit guarantee in the US Mortgage Market;
2. Private mortgage insurers may arrive to replace the duties of Fannie Mae and Freddie Mac.

Negatives:

1. Mortgage costs will rise across the United States as private mortgage insurers may not arrive to replace the duties of Fannie Mae and Freddie Mac;
2. Many citizens across the United States will have a more difficult time obtaining their dream of home ownership;
3. The 30 year mortgage may disappear;
4. Thousands and thousands of employees at the two GSE's will be terminated;
5. Litigation from past investors in these two entities will continue;

⁹ Remarks by Counselor to the Secretary for Housing Finance Policy Dr. Michael Stegman Before the Goldman Sachs Third Annual Housing Finance Conference
<http://www.treasury.gov/press-center/press-releases/Pages/j19987.aspx>

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6. A loss of market value of the debt of the GSE's being held in many pension funds, state funds, and other investment pools will occur;
7. The U.S. Government will not share in any of the future profits of the GSE's;
Note: The US Government has been the beneficiary of tax receipts and revenues from over 80+ years of Fannie Mae operation and over 40+ years of Freddie Mac operations.

If You Answer the Above Question 2 with 'No':

Allow Fannie Mae and Freddie Mac to return to a business model where the companies are released from conservatorship, rebuild capital and operate under the revised guidelines. *Note: a video can be watched featuring Dr. Cliff Rossi, the former senior risk management official at Freddie Mac and Freddie Mac. The video is titled 'Government's Path Out of Conservatorship for Fannie Mae and Freddie Mac' linked from the investorsunite.org website:*

<https://www.youtube.com/watch?v=3kbFqpHfAu8&feature=youtu.be> &a).

The question also arises as to 'what method do Fannie Mae and Freddie Mac have to rebuild capital'? If Congress thinks that private capital will return to provide capital into companies that have been taken into conservatorship without any compensation to prior investors, this is a wrong hypothesis which can be evidenced by looking at many disputes currently taking place in various legal venues across the United States.

Current Situation:

The US Government, through the actions of the US Treasury and the FHFA place the GSE's in a limbo world, not only a place where the long-term position is untenable but where the actions of the US Treasury and the FHFA are schizophrenic.¹⁰ Parts of the Government are saying that they do not want to be involved in the U.S. Mortgage Market but that is exactly what the US Government is doing by retaining the companies in conservatorship. The U.S. Government has inserted themselves into the operations of GSE's by taking all the profits but not letting the GSE's repay any past loans from the US Treasury.¹¹ The untenable position of the U.S. Treasury can be expressed simply by stating that the U.S. Government is talking out of both sides of its mouth...you cannot have it both ways, you cannot say you want to be out of the US Housing Market but then remain involved and take all the profits from the ongoing operations of the GSE's.

¹⁰ <http://themreport.com/news/government/04-02-2015/former-fdic-chairman-criticizes-lack-of-gse-reform>

¹¹ An example of the heated legal issues and disputes can be found in an article published in Forbes, 2014: titled 'Will Fannie and Freddie Shareholders Be Able to Set Aside the Third Amendment? Judge Royce Lamberth's Indefensible Decision Is Only One Battle in a Long War*':
<http://www.forbes.com/sites/richardepstein/2014/09/30/will-fannie-and-freddie-shareholders-be-able-to-set-aside-the-third-amendment-the-recent-sweeney-decision-will-not-alter-the-basic-dynamics/>

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During the financial crisis of 2008 through 2012, the United States Treasury provided a combined loan to the GSE's in the amount of \$188 Billion dollars. As of February, 2015, \$228 Billion has been paid back by Fannie Mae and Freddie Mac but the debt still remains unpaid.¹² This situation has also caused numerous lawsuits at various levels of both district and appeals courts which may continue with legal disputes and appeals all the way to the United States Supreme Court.¹³

An alternative would be to say that the US Government is currently involved in the US Mortgage Market by providing a capital cushion but the US Government does not want to be involved after the capital of the companies reaches a certain level (i.e. 5%) to provide a backstop to the ongoing operations of the GSE's. As the warrants owned by the US Treasury provide effective ownership of eighty percent (80%) of the GSE's to the US Treasury, the U.S. Government effectively controls the capital guidelines of the companies going forward.

A Simple Solution to GSE Reform: Actual Steps to a Fourth Amendment to Release GSE's and Continue Future Operations with Revised Charters, Capital Levels and Operational Guidelines

<u>Steps</u>	<u>Positives / Negatives</u>
Step 1: Support the creation of a fourth amendment to the Preferred Stock Purchase Agreement between the Federal Housing Finance Administration and the US Treasury	Avoid lengthy drafting of legislation in both the U.S. Senate and the House of Representatives that may be difficult to pass on either floor.
Step 2: Declare the US Treasury as paid back by the two GSE's.	<p>Factual: Return of payments from Fannie Mae and Freddie Mac total approx. \$50 billion in excess of the original amount loaned.</p> <p>Future litigation involving a 'takings claim' by private investors against the US Treasury will likely be successful at some time in the future. (FOOT NOTE: Judge Laberth's Ruling)</p>

¹² Representative Michael Capuano (D-MA) introduced H.R. 1036, the "Let the GSEs Pay Us Back Act" on February 24, 2015. <http://nlihc.org/article/house-bill-would-allow-fannie-and-freddie-pay-back-bailout>

¹³ Freddie Mac, Fannie Mae Cases Move Ahead Amid Appeals Fight
<http://www.bloomberg.com/news/articles/2015-01-28/freddie-mac-fannie-mae-lawsuits-to-move-forward-judge-rules>

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<p>Step 3: US Treasury: exercise the warrants and sell any percentage (over time) of the eighty percent (80%) ownership that the US Treasury holds in the GSE's. Capital from the sale of the equity / warrants would be placed directly into the capital of the GSE's. The US Treasury could expect to receive in excess of one hundred billion dollars from this eighty percent (80%) ownership position.</p>	<p>The exercise of warrants / sale of equity that the US Treasury would have in the GSE's could be done over a period of several years, with greater than approx. one hundred billion dollars of capital raised for the GSE's as capital cushion.</p> <p>Alternative Note: The US Treasury could also simply hold the equity and retain a high percentage ownership and representation on the boards of the GSE's, which would result in the US Treasury controlling the timing of any dividends / payout from the GSE's balance sheets. The result would be the US Treasury (as majority shareholders) would have strong control and directive over the capital accounts of the post conservatorship GSE's entities.</p>
<p>Continue to have oversight and board representation by the FHFA into the future operations of the GSE's, requiring that a minimum capital cushion of five percent (5%), as directed and provided by US Government / Congressional guidance of the loan portfolio be required to be maintained at all times as capital.</p>	<ul style="list-style-type: none"> • The GSE's can rebuild capital based on directions and involvement of the FHFA. • No new entities need to be created. • The secondary market for current GSE's mortgage securities remain in good standing and are openly traded. • Additional capital can be raised from the private sector either through equity or debt financing. • A resolution of current lawsuits can be achieved • Future treatment of investors in these entities will be viewed more favorably than in event that a 'takings' claim is successful through the US Court system against the US Treasury and FHFA.

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Additional Positives:

- Thousands of current Fannie Mae and Freddie Mac employees retain their jobs.
- The US Government may remove financial involvement at a timing and discretion of their choosing.
- No additional difficulty of having to capitalize a new mortgage chartered entity.
- No hidden cost of lowered values for current Fannie Mae and Freddie Mac debt securities would occur in the portfolios in many of the State Funds, Pension Funds and other investment assets / pools held across America.
- Continuation of current twenty (20) year and thirty (30) year home mortgage.

Additional Negatives:

The US Government may still continue to have some involvement in the mortgage market albeit with lowered capital exposure and revised operational guidance.

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QUICK FINANCIAL ANALYSIS:

Market Value of FNMA / FREDDIE MAC (000's):

Annual Expected Earnings of FANNIE MAE:¹⁴	10,000,000
Valuation of company using at a 12 to 1 P/E:	120,000,000
Government Share: (80%)	96,000,000
Private Sector Share: (20%)	24,000,000
Annual Expected Earnings of FREDDIE MAC:¹⁵	6,000,000
Valuation of company using at a 12 to 1 P/E:	72,000,000
Government Share: (80%)	57,600,000
Private Sector Share: (20%)	14,400,000
Valuation of US Government share in Fannie Mae and Freddie Mac:	153,600,000

The actual number of years the US Government would have to wait to recover an amount in earnings equal to the amount that the private sector capital markets would be expected to value the common shares of Fannie Mae and Freddie Mac (equal to \$153 B. dollars) is 9.6 years.¹⁶

Immediately releasing the GSE's from conservatorship and allowing Fannie Mae and Freddie Mac to return to operation with revised operational guidelines allows the US Treasury a method of recouping greater amount of capital versus waiting approximately ten years to recover an equivalent amount through the quarterly / annual profit sweep. At the same time the US Government is provided the opportunity through an eighty percent (80%) ownership position to exercise guidance for the future operations of both of the GSE's. Following this path, the US Treasury could exit and / or stay involved as long as they held a majority equity position. Applying this method and following this path, does not restrict the US Government to changing the Freddie Mac and Fannie Mae charters in the future, it simply provides a method for the US Government to gracefully exit their involvement.

¹⁴ <http://www.fanniemae.com/portal/about-us/investor-relations/quarterly-annual-results.html>

¹⁵ <http://www.freddiemac.com/investors/er/>

¹⁶ Actual earnings cannot be forecast with certainty, but earnings in this range are a reasonable low end projection based on historical earnings of the companies.

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Closing Statement:

Over one year has passed since our January, 2015, meeting with Congressional staff members in numerous offices where we discussed an idea about a future path for GSE reform that may fit Senator David Perdue's 'Simple Solution' message and the solution is still so very obvious. I write to you as a homeowner with a mortgage, as well as small business owner, private investor and taxpayer residing in Georgia. Like many others, I do not believe the current position of the US Treasury and the FHFA will be defensible in court over the long-term.¹⁷

A simple solution to GSE Reform is create a fourth amendment to release the GSE's and continue future operations with revised charters, capital levels and operational guidelines. Furthermore, as the simple financial analysis provided in this letter displays, the US Government would be in a better position by simply ending the conservatorship and accepting the eighty percent (80%) financial ownership in the GSE's versus fighting these lawsuits for years and what would be seen as unfair treatment of current investors. Current investors need to be treated with the rights of investments held with proper protection from the conservator. Private capital will be needed on the balance sheet of the GSE's in the future and how will capital be raised for the GSE's if the rule of law is not followed? The US Government can take this path of ending the conservatorship, allowing the GSE's to recapitalize, holding their majority equity stake, and then make a simple choice as to what type of involvement the US Government would have in the future.

My group and I very much appreciated the chance to visit with you and all of the other individuals across numerous House and Senate offices in the US Congress. I hope you consider the points in this letter as questions and issues arise in Congress related to the path of future GSE reform.

Sincerely,

Michael Meyer

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¹⁷ Recent decision in US District Court cites that claims may not be ripe - https://ecf.dcd.uscourts.gov/cgi-bin/show_public_doc?2013mc1288-46: Further claims / appeals will continue: <http://capwealthadvisors.com/1832/pagliara-lamberths-decision-on-fannie-freddie-just-the-beginning/>