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PIMCO

Via Electronic Submission

August 31, 2020

The Honorable Mark Calabria, Ph.D.
Director
Federal Housing Finance Agency
Division of Conservatorship
400 7th Street, SW, 8th Floor
Washington, D.C. 20219

Re: Proposed Rule - Enterprise Regulatory Capital Framework
(RIN: 2590-AA95)

Dear Director Calabria,

Thank you for inviting public comment on the Federal Housing Finance Agency ("FHFA") *Proposed Rule on Enterprise Capital.* We appreciate the opportunity to provide our thoughts, and we do so in the capacity as one of the largest investors in Fannie Mae ("Fannie") and Freddie Mac ("Freddie") (collectively, the "Enterprises" or "GSEs") mortgage backed-securities ("MBS" or "Agency MBS") and non-agency mortgage whole loans and securities ("RMBS") globally. Pacific Investment Management Company LLC ("PIMCO") is the largest active fixed income manager globally, and as of June 30, 2020, manages $1.92 trillion of assets on behalf of millions of individuals and thousands of institutions globally; in all cases, we function in a fiduciary capacity and are legally obligated to act in the best interests of our clients.

We broadly support the efforts by the FHFA to ensure that the GSEs are appropriately capitalized so to ensure they can continue to play their vital role in the housing finance market as Congress envisioned. As significant participants in the mortgage market, we know firsthand how critical the GSEs are in terms of delivering access to housing finance for millions of American borrowers, facilitating homeownership for underserved communities, and supporting a vital and substantial sector of the economy.

However, as we elaborate below, if the proposed capital rule and the subsequent raising of capital is simply being taken as a precursor to releasing the GSEs from conservatorship unilaterally without Congress, we encourage the FHFA to rethink its actions. In fact, if the FHFA proceeds as it has indicated without Congress first legislating an explicit full-faith-and-credit government guarantee for GSE-issued MBS, we are worried that the GSEs will likely not be able to fulfill their statutory obligations: Mortgage rates will increase, homeownership will likely suffer, and the national mortgage rate will no longer exist. Moreover, as elaborated below, a fundamental conflict exists between releasing the GSEs from conservatorship and the GSEs achieving their affordable housing goals.

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In the proceeding comments, PIMCO will share its views on: (1) the important function that the GSEs serve today; (2) the importance of the explicit government guarantee; (3) the impact of releasing the GSEs from conservatorship unilaterally without Congressional action; (4) the inadequacy of capital as a replacement for the guarantee and the impact on mortgage rates under the framework; and (5) a way forward that would both shrink the government footprint and honor the GSEs' affordable housing goals.

1) The role the GSEs serve in the market today

The importance of the GSEs cannot be overstated. Financing by the GSEs has allowed millions of Americans to buy their own homes, creating stability and generating wealth for Americans for generations. The country's homeownership rate of ~67.9%[1] has largely been enabled by the housing giants, and housing continues to be a major asset for many Americans; indeed, housing as an asset accounts for 25% of total household net worth or $20 trillion of home equity in the United States.[2]

The GSEs are and always have been non-economic buyers of mortgage loans, and this is precisely how Congress envisioned them.[3] They were established to take risks that others would not or could not in order to provide liquidity when no one else would or could. Indeed, the GSEs were the only buyers of mortgage loans on the day of the Long-term Capital hedge fund failure, the only buyers of mortgage loans on 9/11/2001, and are particularly relevant today as the only buyers of post-COVID loans. In fact, as of 2Q 2020, the GSEs accounted for 65% of all residential mortgage originations, and when Ginnie Mae is taken into account, nearly 75% of originations; this compares to the tiny 1% for the private label securities (PLS) market (see below). While the current GSE market share is outsized as a result of the ongoing COVID-19 crisis (it usually cycles between 45% and 50%), the role the GSEs are playing in today's market is exactly as Congress envisioned it: The GSEs are providing counter-cyclical liquidity when few providers, if any, will. Perhaps unsurprisingly, the GSE share of the origination market has now rebounded to the levels last reached in the previous crisis in 2008-2009.[4]

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[1] U.S. Department of Commerce, U.S. Census Bureau, Release Number: CB20-107, *Quarterly Residential Vacancies and Homeownership, Second Quarter 2020*, 1 (July 28, 2020), https://www.census.gov/housing/hvs/files/currenthvspress.pdf.

[2] Hannah Hall, Eric Nelson and Kamila Sommer, Board of Governors of the Federal Reserve System, FEDS Notes, *A New Measure of Housing Wealth in the Financial Accounts of the United States*, 1 (Sept. 28, 2018), https://www.federalreserve.gov/econres/notes/feds-notes/new-measure-of-housing-wealth-in-the-financial-accounts-of-the-us-20180928.htm.

[3] Congressional Research Service, *Fannie Mae and Freddie Mac in Conservatorship: Frequently Asked Questions*, 1 (May 31, 2019), https://fas.org/sgp/crs/misc/R44525.pdf.

[4] Housing Finance Policy Center, *Housing Finance at a Glance, A Monthly Chartbook*, 6 (July 2020), https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-july-2020.

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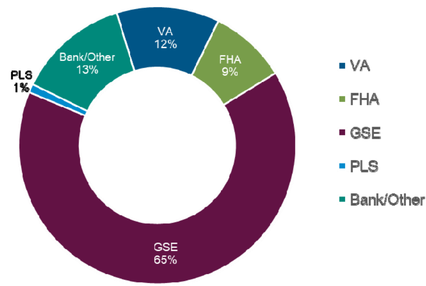

Source: Inside Mortgage Finance; PIMCO

Importantly, the GSEs serve a vital purpose not just in time of crisis: Of the many public goods the GSEs have delivered, the most important is the 30 year fixed national mortgage rate for conforming mortgages. Specifically, for loans sold to the GSEs, borrowers with the same loan-to-value (LTV) and credit score receive the same mortgage rate regardless if they are in North Dakota, California, Florida or New Mexico. In other words, despite substantially different housing market dynamics, borrowers with similar characteristics in Spartanburg, South Carolina can secure the same rate as borrowers in San Francisco, California**.** As we discuss below, it is the explicit government guarantee that facilitates this ability for otherwise similar borrowers to have access to the same homogenous rate across very heterogeneous regional markets.

It is almost impossible to overstate the importance of the national mortgage rate, not only for the primary and secondary mortgage markets, but most importantly, for borrowers and prospective homeowners. For mortgage lenders, it means that they know the GSEs will be able to buy all eligible loans at a certain price. This means that lenders can produce and honor rate sheets for borrowers and brokers. For the GSEs, it also provides the foundation for issuing liquid pools of MBS. Often overlooked, the national mortgage rate is a central underpinning of America's housing finance system and its importance should not be discounted.

The national secondary mortgage market that the GSEs are designed to specifically support includes central cities, rural, underserved areas, low income borrowers, and moderate income borrowers. It is in this affordable housing capacity that the GSEs provide their most distinctive purpose: Providing the means for individual wealth accumulation and neighborhood stability that would not be available without them. Unfortunately, the proposed rule is nearly silent on the impact of the GSEs' affordable housing mandate; in our view, a framework that is practically silent on maximizing this objective is unlikely to satisfy it.

Given their decisive funding advantage and market expansion, both during their time as actively private companies and in conservatorship, the GSEs have injected trillions of dollars of subsidized funding into the housing market. They have done this for over eighty years. The entire U.S. residential mortgage-delivery system is either directly or indirectly mapped to the GSEs operating the way they do. There is no way to fully get the toothpaste back in the tube without causing unnecessary damage to the housing market, taxpayer wealth, borrowers and the economy as a

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whole. Therefore, as we discuss below, the FHFA must be very considered as they proceed with the fate of the GSEs.

2) The importance of the explicit government guarantee

The ability of the GSEs to play a central – and, at times, countercyclical – role in the housing market is directly the result of the relationship that the GSEs have with the U.S. government today and the effectively explicit government guarantee associated with that relationship. As you know, when the GSEs were teetering on financial insolvency in 2008, Congress and the Treasury Department took bold action to shore-up the near insolvent institutions, injecting $191bn in taxpayer money and placing Fannie and Freddie in conservatorship. At that point, Treasury Secretary Paulson was clear about the government's intention: "Treasury took responsibility for supporting the agency debt securities and the agency MBS . . . effectively, a guarantee on GSE debt and agency MBS. . . .The U.S. government honors its commitments, and investors can bank on it."[5] That sentiment is also reflected in the Senior Preferred Stock Purchase Agreement (PSPA) between the FHFA Director as conservator and the Treasury Secretary at the time by explicitly prohibiting any future amendments to the agreement that "adversely affect in any material respect the holders of debt securities of Seller[s] and/or the beneficiaries of Mortgage Guarantee Obligations," the PSPA makes explicit the government's commitment to maintain stability in the MBS market.[6]

Put simply, from a market perspective, the government-managed conservatorship combined with the extensive taxpayer support provided through the PSPAs, transformed the implicit government guarantee into an *explicit guarantee* in September 2008. It is that explicit guarantee that is the basis for today's MBS demand and liquidity. It is precisely because of the explicit guarantee that the GSEs are able to fulfill their Charter-obligated stability and liquidity mandates despite the fact that the GSEs have been insufficiently capitalized since 2008. It is the explicit government guarantee that facilitates the ability for similar borrowers to obtain the same national fixed mortgage rate across heterogeneous regional markets; without such a guarantee, investors would have to take into consideration where a borrower lives, the liquidity of the underlying market, etc. – and ultimately price in those differences and the corresponding risks associated with them. In all likelihood, that would mean that borrowers in housing markets that are less dense, less liquid, and are more rural would invariably face higher mortgage rates, and in the extreme, face a lack of access to credit altogether.

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[5] Henry M. Paulson, Secretary, U.S. Department of the Treasury, *Remarks on Financial Rescue Package and Economic Update*, 2 (Nov. 12, 2008), https://www.treasury.gov/press-center/press-releases/Pages/hp1265.aspx.

[6] Senior Preferred Stock Purchase Agreement, US Department of Treasury and Federal National Mortgage Association, § 6.3 (Sept. 7, 2008), https://www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/FNM/SPSPA-amends/FNM-SPSPA_09-07-2008.pdf; Amended and Restated Senior Preferred Stock Purchase Agreement, US Department of the Treasury and Federal Home Loan Mortgage Corporation, § 6.3 (Sept. 26, 2008), https://www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/FRE/SPSPA-amends/FRE-SPSPA_09-07-2008.pdf.

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3) Consequences of a release from conservatorship without Congressional action to establish an explicit government guarantee would be negative – and possibly significantly so

Despite the GSEs having performed well through a variety of markets since 2008, including the most recent COVID-related shock, PIMCO understands that the FHFA continues to be interested in responsibly ending conservatorship. While the focus to release the GSEs from conservatorship is understandable, we believe that any release particularly *prior* to Congressional action would have unfavorable – and likely dramatic – consequences. We strongly believe that market participants will not view the release of the GSEs as a return to the implied guarantee model that prevailed before the financial crisis, but rather, they would view them as wholly-owned private companies with no accompanying government guarantee. In other words, if the GSEs were released from conservatorship, a guarantee would either be explicit (provided by Congress) or it would explicitly not exist – there is no in-between from the market's view.

Without an explicit government guarantee, many of the existing holders of GSE MBS, including clients of PIMCO's, would find it harder to invest in the GSE MBS market, leading likely to forced-selling and less appetite for MBS going forward. As described above, investors view the government control of the GSEs in conservatorship as precisely what former Treasury Secretary Hank Paulson described in 2008 – an explicit government guarantee. It is this guarantee that has made the GSE MBS market the world's second most liquid bond market, only to U.S. Treasuries. Because of the guarantee, investors do not have to concern themselves with the credit risk of the underlying borrowers or the dynamics of the underlying housing market because they know the principal and interest is backed by the full faith and credit of the U.S. government. As a result, there is a deep pool of capital that is willing to buy GSE-issued MBS - from the Federal Reserve to sovereign-wealth funds to insurance companies, to local, regional, national and international banks, to retail investors in mutual funds.

If there were no explicit guarantee upon release of conservatorship, many of these entities would no longer be able to buy, and in some cases, even hold MBS either by law or by their investment guidelines– or at least, they would be unable to do so in the size they can today given single-credit concentration limits. Indeed, investors in GSE MBS desire interest rate risk, not credit risk, and without an explicit government guarantee, GSE MBS would be viewed as any other corporate bond with implied credit risk. The consequence will be that the GSEs become just another corporate credit subject to client or regulatory concentration limits.

Because the pools of capital that are able to invest in credit risk are significantly smaller than those allowed to invest in pure interest rate risk, GSE MBS without an explicit guarantee would have to be priced and sized accordingly, leading invariably to a significantly less liquid market (since there would be less demand) and higher borrowing rates (since investors would demand a higher return to compensate them for the credit risk). Reflexively, these investors would flock to Ginnie Mae MBS, which *does* provide an explicit government guarantee. Given that there are 2.5x more GSE MBS than Ginnie Mae MBS, the potential flood of net MBS sales would likely significantly depress MBS, unless the Federal Reserve is prepared to absorb it all. In the absence of the Fed purchasing the GSE MBS, prices would likely decline, borrowing rates would increase, and house prices nationally would follow suit. Despite all of this, the government's footprint in housing finance

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would remain unchanged. Put simply: The GSEs cannot serve their Charters without an explicit government guarantee. Continuing to deny what the MBS market views to be self-evident will harm housing-prices, current taxpayers, prospective borrowers and the economy as a whole.

From the borrowers' perspective, a release from conservatorship without Congressional action would likely disproportionately impact borrowers with less-than-pristine credit profiles and those who live in rural states who have benefited from the national mortgage rate. In other words, it is not the borrower in the liquid housing market of San Francisco who would necessarily be impacted, but the one in the much less liquid and less dense market of Spartanburg, South Carolina.

To compound the cost to homeowners, after they are privately-owned companies once released from conservatorship, the GSEs would be bound by their duty to maximize shareholder value, i.e., to optimize the return on equity (ROE). Meeting the ROE required by equity investors would provide additional pressure to increase guarantee fees, especially for the least profitable and riskiest borrowers. This would inevitably impinge on their ability to satisfy their Charter purposes, particularly as it relates to their affordable-housing goals. Supporting affordable housing is central to the GSEs' Charters. Affordable housing is the reason there is a conforming loan limit in the first place. We believe that to satisfy ROE targets as private entities, there would be increased pressure to focus on and potentially increase the upper bound of the conforming loan limits, a segment of the market where borrowers accessing subsidized financing don't need it; this is likely to increase the price and size of houses, reduce access to affordable housing, and importantly, the incentives of builders to produce affordable housing.

4) Capital is not a replacement for an explicit government guarantee

Implicit in the FHFA's proposed capital rule is that the recommended capital framework is sufficient to replace the now-explicit government guarantee. We fundamentally disagree with this premise and do not believe any reasonable level of capital can replace an explicit government guarantee. As stated previously, the GSEs have been able to support the US housing market for the last 12 years *not* because of a specific capital level, but because of the ongoing conservatorship and the effective explicit government guarantee associated with it.

While some have suggested that maintaining the roughly $250 billion line of credit between the GSEs and the Treasury Department contained in the Preferred Stock Purchase Agreement (PSPA) will help ease concerns regarding an administrative exit, we would argue that is not the case. An increase in capital may comfort investors who hold equity in the GSEs, but it will not assuage MBS investors. MBS investors are focused on the guarantee of the MBS – whether their principal and interest is explicitly guaranteed or not, not the capital positions of the GSEs. Moreover, the PSPA support is subject to significant political risk: It is a bilateral agreement and contingent not only on the party in power in the White House, but the personnel who are in place at the FHFA and the U.S. Treasury Department. Moreover, the PSPA has been amended multiple times and could be further changed or eliminated at any point in the future. In other words, the impact of the GSEs' ability to raise that capital is of no consequence to MBS investors.

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If the FHFA were to move forward without Congressional action on an explicit government guarantee and implement its capital framework as proposed, we would contend the proposed level of capital would be significantly insufficient. Indeed, absent an explicit full-faith-and-credit guarantee of the U.S. government, common equity tier 1 capital should be sufficient to unquestionably cover all GSE MBS guarantee obligations; moreover, our estimate of *unquestionably sufficient* capital to meet these obligations is more than three times what is recommended under this proposal.

What is more, for risk-based capital frameworks to be effective, we believe the associated risks must be clearly identifiable and easily calculated in all possible states. Mortgage-related risks, as the proposed rule vividly illustrates, are complex and interrelated, hence the FHFA's inclusion of multiple buffers and the leverage ratio. Nevertheless, the proposed risk-based capital is roughly half of that for mortgage loans included in the Basel rules in spite of the banks having broader business-lines and more geographic diversification. This is difficult for us to reconcile. The primary credit-risk mitigation tool utilized by the GSEs, private mortgage insurance, is available to banks, yet banks receive no capital relief for it, unlike what has been put forth in the proposed rule.

Also implicit in the framework is the ability to continuously fund loan purchases by issuing MBS. Post-COVID, 60% of the GSEs' current loan acquisitions are cash purchases. According to eMBS data, combined July 2020 MBS issuance totaled $231.7 billion, or $139 billion of loan acquisitions through the cash window. If the GSEs are unable to efficiently issue MBS, due to the lack of a credible guarantee, it follows that it will be difficult and costly to fund the current volume of cash loan purchases. This cost will be passed on to borrowers, as it was post-COVID until the Federal Reserve became the buyer of last resort. Under the PSPA, it is currently prohibited for the GSEs to increase the size of their retained investment portfolios.

We are also concerned that with no explicit guarantee but only increased capital, the GSEs would become a pro-cyclical force; in others words, in a time of an economic downturn, in the absence of a government guarantee, we worry that mortgage rates would increase significantly, making housing less affordable and access to credit harder to come by – exactly the opposite of what policymakers would presumably want in a recession.

5) Any realistic proposed capital framework without an explicit government guarantee means affordability will decrease for low-to-moderate income borrowers; the FHFA is better-served slowly shrinking the GSE footprint

While we maintain that there will be no to-be-announced (TBA) market for GSE-issued MBS without a full-faith-and-credit government guarantee, the following tables illustrate the impact to borrowers of various required capital levels and required returns on equity. The tables solve for the guarantee fee required to generate various returns on equity given a capital requirement and adjusts today's prevailing note rate accordingly. The baseline assumptions are a current mortgage (note) rate of 3.00% for GSE-eligible loans, a $250,000 loan amount, and a 0.60% guarantee fee, with zero losses.

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Table 1 illustrates that under our estimates of what investors would seek to earn and the required levels that rating agencies would require to issue a AAA rating to GSE-issued MBS without a government guarantee, a borrower's note rates would be required to increase by 40%-50%.

Table 1

		Table values = Implied Borrower Note Rate by Required Return/Required Capital								
		Current 30-yr Fixed-Rate Mortgage = 3.00%								
		Required Capital								
		2%	4%	6%	8%	10%	12%	14%	16%	18%
Return on Equity	3%	2.45%	2.50%	2.55%	2.60%	2.65%	2.70%	2.75%	2.80%	2.85%
	5%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%
	8%	2.55%	2.70%	2.85%	3.00%	3.15%	3.30%	3.45%	3.60%	3.75%
	10%	2.60%	2.80%	3.00%	3.20%	3.40%	3.60%	3.80%	4.00%	4.20%
	13%	2.65%	2.90%	3.15%	3.40%	3.65%	3.90%	4.15%	4.40%	4.65%
	15%	2.70%	3.00%	3.30%	3.60%	3.90%	4.20%	4.50%	4.80%	5.10%
	18%	2.75%	3.10%	3.45%	3.80%	4.15%	4.50%	4.85%	5.20%	5.55%
	20%	2.80%	3.20%	3.60%	4.00%	4.40%	4.80%	5.20%	5.60%	6.00%
	23%	2.85%	3.30%	3.75%	4.20%	4.65%	5.10%	5.55%	6.00%	6.45%
	25%	2.90%	3.40%	3.90%	4.40%	4.90%	5.40%	5.90%	6.40%	6.90%

Table 2 translates the results from Table 1 into annual differences in actual costs. In dollar terms, that is $2,022 - $2552 from current costs. Another way that can be phrased is that the price of releasing the GSEs from conservatorship without a full-faith-and-credit guarantee is a 4% housing tax on median income borrowers. And absent an implicit or explicit guarantee, the ability of the GSEs to maintain a substantial cross-subsidy will likely evaporate as they are obligated to maximize ROE. Inevitably costs on low and moderate income borrowers will increase more than the median borrower.

Table 2

		Table values = Implied Annual Borrowing Cost Change -- $250,000 loan amount								
		Current 30-yr Fixed-Rate Mortgage = 3.00%								
		Required Capital								
		2%	4%	6%	8%	10%	12%	14%	16%	18%
Return on Equity	3%	$ (872)	$ (794)	$ (716)	$ (638)	$ (559)	$ (480)	$ (401)	$ (321)	$ (241)
	5%	$ (794)	$ (638)	$ (480)	$ (321)	$ (161)	$ -	$ 162	$ 326	$ 491
	8%	$ (716)	$ (480)	$ (241)	$ -	$ 244	$ 491	$ 740	$ 991	$ 1,245
	10%	$ (638)	$ (321)	$ -	$ 326	$ 656	$ 991	$ 1,331	$ 1,674	$ 2,022
	13%	$ (559)	$ (161)	$ 244	$ 656	$ 1,076	$ 1,502	$ 1,935	$ 2,375	$ 2,821
	15%	$ (480)	$ -	$ 491	$ 991	$ 1,502	$ 2,022	$ 2,552	$ 3,092	$ 3,640
	18%	$ (401)	$ 162	$ 740	$ 1,331	$ 1,935	$ 2,552	$ 3,183	$ 3,825	$ 4,480
	20%	$ (321)	$ 326	$ 991	$ 1,674	$ 2,375	$ 3,092	$ 3,825	$ 4,574	$ 5,338
	23%	$ (241)	$ 491	$ 1,245	$ 2,022	$ 2,821	$ 3,640	$ 4,480	$ 5,338	$ 6,215
	25%	$ (161)	$ 656	$ 1,502	$ 2,375	$ 3,274	$ 4,198	$ 5,146	$ 6,117	$ 7,110

Disregarding PIMCO's belief that the capital required to provide a credit risk-free MBS guarantee is inadequate, it is difficult to see a path toward raising even the comparatively modest amounts of capital proposed, given the intractable conflicts between the GSE Charters and maximizing shareholder value. Combine this with the practically unbounded statutory powers of the FHFA Director, and the proposed framework is simply not tenable.

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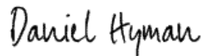
We believe the FHFA would be better-served taking another path. After all, the GSEs effectively failed as private companies; the experience leading up to 2008 underscored that the GSEs as private profit-maximizing firms cannot fulfill the Charter and their duties to shareholders. This was not due to a failure of management or insufficiently clever regulation. Rather, it was the result of the intrinsic contradictions between the Charters' requirements and the purposes and objectives of a private company. There is nothing in the proposed framework that resolves these contradictions, and we believe that it is a mistake to believe "this time will be different" – the consequences of which could be even more severe this time given the increase in the GSEs' size and share of the market.

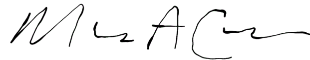
We nevertheless strongly support the charter mission of the GSEs and the public goods it provides. Broadly, we support smaller charter-mission focused *public* GSEs, with government-guaranteed MBS, dedicated to increasing access to mortgage credit for low and moderate income borrowers and maximizing liquidity, including the ability of the GSEs to be the MBS buyer of last resort – filling vacuums that may exist as a result of periodic dislocations, such as those caused by COVi-19. Many of the policy objectives that the proposed framework attempts to achieve – increased competition, efficiency, and resiliency – are more effectively achieved by reducing the GSEs' size and scope. Reducing the footprint could quickly be achieved through limiting the allowable loan sizes; eliminating cash-out refinancings, other than for debt consolidation; and/or eliminating eligibility for second homes. A combination of these changes is also the simplest and surest way to address too-big-too fail concerns.

The principal policy objective of the GSEs is to focus subsidized borrowing to the borrowers who need it. More than enough lending capacity from banks and other deep pools of private capital are available to satisfy the demand for loan sizes greater than the conforming loan limit. Maximizing private mortgage lending, while retaining GSE-provided public goods – including the national mortgage rate, automated underwriting, documentation and servicing standards and overall liquidity – reduces taxpayer exposure, and it concentrates the enormous effectiveness of the GSEs on maximizing affordable lending. Releasing the GSEs as private companies will not only fail to produce these benefits, but if past is prologue, will likely end in another bail-out by way of conservatorship.

Sincerely,



Dan Hyman, Managing Director
Head of Agency Mortgage Trading
PIMCO



Mike Cudzil, Managing Director
Portfolio Manager
PIMCO

Kent Smith, Executive Vice President
Portfolio Manager
PIMCO

Libby Cantrill, Managing Director
Head of Public Policy
PIMCO