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MARCIE R. ZIEGLER

LAW OFFICES
WILLIAMS & CONNOLLY LLP

725 TWELFTH STREET, N.W.
WASHINGTON, D. C. 20005-5901

(202) 434-5000

FAX (202) 434-5029

www.wc.com

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Via E-mail

Gary J. Cohen, Esq.
General Counsel
Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue, NW, Suite 800
Washington, DC 20006-4614

Dear Mr. Cohen:

I write on behalf of former Treasury Secretary Henry M. Paulson, Jr. in response to your December 16, 2010 letter. Your letter sets out several remarks attributed to Secretary Paulson that the Commission proposes to use in its upcoming report. These remarks are taken from an unrecorded and untranscribed interview that Secretary Paulson gave to the Commission in April of this year to help the Commission understand the role of the GSEs—Fannie Mae and Freddie Mac—in the financial crisis. What is most striking about your letter is what it suggests the Commission *does not* intend to include in its report, namely, Secretary Paulson's account of his efforts to secure GSE reform after he took office in 2006 and his account of his efforts to prompt the GSEs to raise needed capital in the spring of 2008.

As Secretary Paulson explained to the Commission, his view from the start of his tenure as Treasury Secretary was that the GSEs had an inherently flawed structure of private funding backed by implicit government support, overseen by a weak regulatory agency that had no power to adjust statutorily mandated capital requirements. As a consequence, although Treasury was not the GSEs' regulator, Secretary Paulson devoted significant energy throughout his time in office seeking reforms that would secure a stronger, more flexible regulator for the GSEs. Those efforts were consistently stymied by a lack of political consensus until the summer of 2008 when the fear of an impending crisis prompted Congress to enact legislation reforming the GSEs. From your letter, it appears that the Commission does not intend to recount this history fully.

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It also appears from your letter, that the Commission does not intend to recount fully the nature of Secretary Paulson's efforts in the spring of 2008 to prompt the GSEs (along with other private financial institutions) to raise capital as a bulwark against a severe financial downturn. As Secretary Paulson explained to the Commission, he was concerned by early 2008 that many firms in the financial sector were holding insufficient capital, and, although he could not directly regulate those firms, he began to encourage them publicly to raise capital, often reminding them that "No institution ever got into trouble by having too much capital." After the collapse of Bear Stearns in March 2008, Secretary Paulson made further efforts to prompt the GSEs in particular to raise additional capital. He spoke directly with the GSEs' regulator and their CEOs and obtained a commitment from the GSEs that they would raise additional capital in return for a reduction in their existing capital surcharge. The purpose of this action—as Secretary Paulson made clear to the GSEs, their regulator, and the Treasury staff involved in implementing the final agreement—was to make the GSEs raise capital, and that is precisely what it did. Fannie Mae raised approximately \$7 billion in new capital in the subsequent months.

It is surprising that the Commission would omit these important narratives from its report to the American people, particularly given the amount of time Secretary Paulson devoted to describing these events to the Commission, both in his informal interview and in his public testimony. *See, e.g.*, Commission Memorandum for the Record, 1-5 (Apr. 2, 2010); Hr'g Tr., 51-56, 65-66 (May 6, 2010). I trust further edits to the final report will rectify these omissions.

With respect to the quotes the Commission currently proposes to use, several of them are inaccurate or lacking necessary context.

First, your letter states that Secretary Paulson told the FCIC that, after he was briefed on the GSEs in June 2006, he believed they were "a disaster waiting to happen." Secretary Paulson did not say that in his interview (a fact that is reflected in the Commission's own memorandum regarding that interview). That phrase was used by Commission staffer Chris Seefer, who was quoting from Secretary Paulson's book, *On the Brink*. *See On the Brink*, 57 (Feb. 1, 2010) ("In short, Fannie and Freddie were disasters waiting to happen. They were extreme examples of a broader problem that was soon to become all too evident—very big financial institutions with too much leverage and lax regulation."). If the Commission quotes from Secretary Paulson's book, please cite to the book.

Second, your letter states that Secretary Paulson learned in 2006 that the GSEs depended on "bullshit capital." What Secretary Paulson said in his interview was that one of the GSEs' problems was that they had statutorily defined capital and a regulator who had no discretion to adjust the level of that capital. Secretary Paulson then commented that some people referred to this type of capital as "bullshit capital." Indeed it was his concerns about the nature

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of the GSEs' capital that prompted Secretary Paulson to push for reform that would provide the GSEs' regulator with the capital regulatory powers of a bank safety and soundness regulator.

Third, the quote your letter attributes to Secretary Paulson regarding the summer of 2007 is not accurate. Secretary Paulson explained that in 2007, after the housing market dried up, responsible people could not buy homes or refinance and the GSEs were the only available source of mortgage funding. He explained that, in his view, the key to getting through that crisis was to limit the decline in housing, prevent foreclosures, and ensure continued mortgage funding, all of which required the GSEs to remain viable.

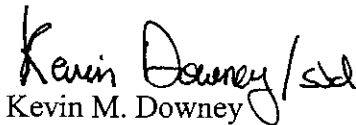
Fourth, the quote your letter attributes to Secretary Paulson regarding the GSEs being the "engine needed to get through the problem" is misleading if not placed in the proper timeframe. The "problem" referenced was the economic situation in the spring of 2008.

Fifth, the quote your letter attributes to Secretary Paulson regarding an agreement with the GSEs being a "no-brainer" is misleading if the agreement is not accurately described. The agreement to which Secretary Paulson was referring was the GSEs' commitment to raise capital that is discussed above.

Sixth, the quote your letter attributes to Secretary Paulson regarding his being "naïve" enough to believe that the strains in the financial system were "all about the housing crisis" is not accurate. What Secretary Paulson said was that in the summer of 2008 he was naïve enough to believe that placing the GSEs in conservatorship would halt the crisis because it would put a floor under the housing decline and provide confidence to the market.

Please correct these references to Secretary Paulson's remarks before including them in the Commission's report. If you have any questions, please feel free to contact me.

Very truly yours,


Kevin M. Downey

cc: FCIC Commissioners (by courier)