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WARREN E. BUFFETT, CHAIRMAN

October 6, 2008

The Honorable Henry M. Paulson, Jr.  
Secretary of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Dear Hank:

I have previously mentioned to you my thought that an investment fund could be formed that would address some of the public's concerns about Treasury's plans to purchase illiquid mortgages. In this letter, I will spell out my thinking in greater detail.

Some critics have worried that Treasury won't buy mortgages at prices close to the market but will instead buy at higher "theoretical" prices that would please selling institutions. Critics have also questioned how Treasury would manage the mortgages purchased: Would Treasury act as a true investor or would it be overly influenced by pressures from Congress or the media? For example, would Treasury be slow to foreclose on properties or too bureaucratic in judging requests for loan forbearance? Additionally, many who are comfortable with a Department of the Treasury headed by someone with your market knowledge are worried about how the investment program would be administered by a future Treasury Secretary who had to rely on a bureaucracy to make important market decisions.

What I would like to suggest is a program that allows Treasury to buy more than the \$700 billion of assets presently anticipated and allows it to do so in a way that dramatically reduces the risk – to almost zero – that Treasury will lose money on its purchases. Indeed, the program I recommend is highly likely to produce profits. Let's call my proposed entity the Public-Private Partnership Fund (PPPF).

This entity would initially be capitalized with \$10 billion of common stock held by the private sector and \$40 billion of notes owned by Treasury. The notes would be due in ten years and carry an interest rate equal to the rate being paid by Treasury on its ten-year bond at the time PPPF was created. These notes would have absolute seniority. That is, they would be paid in full before the common stock would receive a nickel.

PPPF would operate as a REIT, LLC or in some other form that would receive flow-through tax treatment.

With the funds it had raised, PPPF would buy \$50 billion of mortgages (with a far greater principal amount of course). It would focus on whole loans and residential mortgage-backed securities (RMBS) and stay away from second mortgages and exotic instruments such as CDOs squared. Going by today's prices, much of what PPPF would buy would likely be priced at 50-80% of par.

In time, the mortgages and securities in the portfolio would produce cash, through paydowns or later sales, that could be paid to Treasury and the private investors. The cash would first go to pay off Treasury, until it had recovered its entire investment along with interest. That having been accomplished, the private shareholders would be entitled to recoup both their \$10 billion and a rate of interest equal to that received by Treasury. Finally, any profits would be split with three-fourths going to the shareholders and one-fourth going to Treasury.

Let me sum up the effects of this plan: PPPF's capitalization would turn \$40 billion of Treasury money into \$50 billion of mortgage purchases. More important, Treasury would operate with a \$10 billion "cushion" from loss, because the private money in PPPF would be on the front line, eating that amount of net loss if losses were sustained.

Given this structure, PPPF's shareholders would have every incentive to make intelligent purchases. It should be clear to the American public that purchases are not being made at "bail-out" prices for imprudent institutions, but rather at "intelligent investor" prices for Treasury and PPPF shareholders.

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Exploring the merits of this plan, I have talked with Bill Gross and Mohamed El-Erian of PIMCO, and they have told me they would manage this operation on a pro-bono basis. The managing entity would need a small staff, of course. But overall costs would be minimal and, in any event, would be borne by the common stock, since all expenses and losses would go against their \$10 billion.

I've also talked with Lloyd Blankfein at Goldman, Sachs, who says that firm would work on a pro-bono basis to secure the \$10 billion of equity capital. The company I head, Berkshire Hathaway, would be pleased to invest \$500 million, and I think the remainder of the funds needed would be quickly committed by major institutional investors – perhaps especially pension funds.

The reason why I expect the funds to be readily available is simple: If mortgages are purchased at current levels by an entity employing significant leverage and working with dependable, low-cost funds supplied by the U. S. Treasury, profits are very likely to be good—and perhaps even exceptional. That is true because prices have fallen to a level that reflects the inability of other buyers to obtain leverage. Thus returns for an investment operation that has access to long-term Treasury-type funding should be particularly interesting. Unlevered returns of 10% -- and present buyers are seeking more than this – can turn into 25% returns with the leverage I propose.

Once this program is off the ground, I would suggest that the capitalization of PPPF – both equity and debt – be doubled. In this instance, however, Wall Street firms – again on a pro-bono basis – would offer \$10 billion of PPPF's common stock to the American public on exactly the same terms as those granted the initial institutional investors. If PPPF is going to be a good deal for equity holders – and I believe it will be – I would want to be sure that the average American has a chance to share in such an investment on a basis equal to that secured by Berkshire Hathaway and other institutional investors. If this offer is fully subscribed, Treasury would purchase an additional \$40 billion of notes, giving PPPF total buying power of \$100 billion.

I would be willing to personally buy \$100 million of stock in this public offering. (This constitutes about 20% of my net worth outside of my Berkshire holdings, which as you know are promised to charity.)

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Another detail: In the initial offering to institutions, I would bar hedge funds or other vehicles in which the manager receives an override of profits from investing. I think that in a government-connected enterprise such as this, you would want to have investors receive all of the profits available instead of splitting them with managers taking fat overrides.

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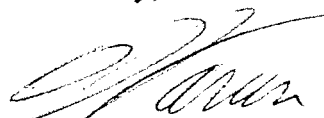
The most likely scenario under which PPPF would prove disappointing is one in which market prices make it impossible for it to buy the contemplated \$100 billion of mortgages at risk-adjusted prices that promise good returns. To cover this possibility, the plan could stipulate that money be proportionately returned to Treasury and to common shareholders if after two years PPPF had been unsuccessful in reaching its goal for purchases.

Alternatively, PPPF could become a purchaser of new “non-conforming” mortgages – those whose size exceeds Freddie and Fannie limits. This move would stimulate the housing market and reduce the high interest rates that non-conforming mortgages now carry (compared to Treasury yields). Any move that PPPF made in this direction would need to be approved by both Treasury and the majority of the common stock. Were this plan to be put into effect, moreover, PPPF should only deal with borrowers putting up downpayments of size, earning comfortable incomes relative to debt service requirements, and supplying documentation of their creditworthiness.

Hank, these are all tentative ideas. But I think it’s enormously important that the public have confidence that Treasury’s activities in the mortgage field are sound and potentially profitable. The public is skeptical – indeed, disbelieving – about this point now, but I believe PPPF could go a long way toward correcting this misconception.

If this plan, or some variation, appears to be feasible, Bill, Mohamed, Lloyd and I – and I’m sure a myriad of others – are ready to help.

Sincerely,



Warren E. Buffett

WEB/db