

CtW Investment Group

September 5, 2007

Kenneth M. Jastrow, II
Lead Independent Director
KB Home
c/o Corporate Secretary
10990 Wilshire Boulevard
Los Angeles, California 90024

Dear Mr. Jastrow:

The collapse of the housing and mortgage markets has destroyed billions in shareholder value at the nation's homebuilders; KB Home investors alone have lost \$1.2 billion this year. Large homebuilders, however, may not merely be casualties of the crisis; as a result of improper business practices, particularly within their mortgage affiliates, several of the nation's largest homebuilders may, in fact, be complicit parties in *causing* the industry-wide collapse. As *Business Week* observed on August 13, "Now that the boom has fizzled and foreclosures are rising, the important role of large homebuilders as lenders is also coming into focus."

With large homebuilders and their business practices under mounting legal and regulatory scrutiny, we call on the KB Home Board of Directors to immediately establish a Legal and Regulatory Compliance Committee ("Compliance Committee") of independent directors to conduct a comprehensive review of the company's compliance status and, based on its findings and recommendations, implement a compliance program to detect and prevent material compliance failures. The need for a dedicated Compliance Committee—common at companies that face significant regulatory and litigation risk—is evident in light of the following:

- Federal and state authorities have stepped up enforcement of existing law and are considering new regulations on homebuilders and mortgage originators. A Senate bill would impose a fiduciary duty on originators, and many in the House and Senate have signaled willingness to place non-bank lenders under federal oversight. Meanwhile, some 30 states are considering bills targeting deceptive lending, foreclosure or fraud.
- An apparent culture of non-compliance has exposed homebuilders and mortgage originators to extensive litigation alleging illegal business practices. Beazer, Centex, D.R. Horton, Hovnanian, NVR, Pulte Homes, Ryland and Toll Brothers are among the homebuilders that have been sued by homebuyers and shareholders so far this year.

KB Home shareholders may ultimately pay the price for any non-compliance. Beazer Homes, for example, has seen its share price tumble roughly 70% since disclosing in March a federal criminal probe into its mortgage practices.

The CtW Investment Group works with pension funds sponsored by unions affiliated with Change to Win, a coalition of unions representing nearly 6 million members, to enhance long-term shareholder value through active ownership. These funds, together with public pension funds in which CtW union members participate, have about \$1.4 trillion in assets and are substantial long-term KB Home shareholders. We detail our concerns further below.

A. Federal and state authorities have stepped up enforcement of existing law and are considering new regulations on homebuilders and mortgage originators.

At the federal level, homebuilders are subject to the Real Estate Settlement Procedures Act (RESPA), which requires advance disclosure of estimated settlement charges and prohibits kickbacks and excessive fees; the Truth in Lending Act (TILA), which requires uniform and accurate disclosure of key mortgage terms and allows borrowers to rescind mortgages where lenders fail to disclose material facts; and the Home Ownership Equity Protection Act (HOEPA), which addresses predatory lending. In response to increased reports of abuse during the recent housing boom, federal agencies have stepped up their enforcement activities. For example:

- In July 2005, KB Home's mortgage unit paid a record \$3.2 million to settle allegations by the Department of Housing and Urban Development (HUD) that it approved loans based on overstated or incorrect income and failed to include all of borrowers' debts, among other practices. As you know, that mortgage unit is now held by a joint venture of KB Home and Countrywide.
- In September 2006, three companies, including homebuilders M.D.C. Holdings and WL Homes, paid a total of \$1.6 million to settle allegations that they violated anti-kickback provisions of RESPA through the establishment of captive title reinsurance businesses.
- In November 2006, the *Washington Post* reported that HUD's RESPA investigators had "become increasingly active in resolving consumer complaints through nonpublic interventions with builders." Among the abuses HUD is investigating: complaints that builders are unfairly forcing buyers to use their affiliated mortgage companies by raising home prices when buyers declined to use their mortgage affiliates and requiring buyers to deposit extra money in escrow accounts if they refuse to use the affiliated lender.
- In March 2007, the Federal Bureau of Investigation, Internal Revenue Service, Inspector General of HUD, and the Justice Department opened a criminal probe into Beazer's lending practices and financial transactions. Subsequently, the Securities and Exchange Commission launched a formal investigation into possible securities law violations by Beazer Homes and its officers and directors. In addition, the company is under civil investigation by the North Carolina Attorney General's office.
- In April 2007, HUD bolstered its RESPA investigative staff to more than 20 and added a private investigative firm. According to HUD, it will use its expanded investigative power to review mortgage and title industry violations and to combat predatory lending, unlawful builder incentives and mortgage fraud. HUD's director of RESPA also predicted RESPA reform by the end of the year.

In response to the mortgage meltdown, there have been mounting calls in Congress for stronger federal regulation, particularly of mortgage lenders such as the one jointly owned by KB Home. Prominent officials have signaled support for placing all non-bank lenders under Federal Reserve oversight. In May 2007, three U.S. senators proposed legislation establishing that non-bank lenders and mortgage brokers owe a fiduciary duty to borrowers, and requiring them to comply

with a standard of good faith and fair dealing. And last Friday, President Bush announced that—in addition to “pursuing wrongdoing and fraud in the mortgage industry” through HUD, the Department of Justice, the Federal Trade Commission, and other agencies—“the federal government is taking a variety of actions to make the mortgage industry more transparent, more reliable and more fair.”

In addition, individual states have stepped up enforcement of predatory lending laws that address practices not covered by HOEPA (39 states have such laws). A number of states, including Arizona, California, Colorado, Florida, Minnesota, Nevada, Virginia and Washington, have been examining affiliated business arrangements between title insurers and captive re-insurers controlled by homebuilders.

Finally, numerous states are moving aggressively to implement new regulations. According to an analysis by *Bloomberg* (7/10/07), lawmakers in 30 states are considering bills to protect borrowers from deceptive-lending practices and foreclosure.

B. An apparent culture of non-compliance has exposed homebuilders and mortgage originators to increased litigation targeting illegal and unethical business practices.

The *New York Law Journal* reported on August 16 that some law firms—including Pillsbury Winthrop, Patterson Belknap, Greenberg Traurig and Paul, Hastings—have recently formed special practice teams in preparation for an expected surge in real estate- and mortgage-related litigation. We believe homebuilders with captive or affiliated mortgage units, such as KB Home, are especially vulnerable since these units create a conflict of interest that requires effective compliance procedures and attentive board oversight. Failure to effectively manage this conflict is at the heart of the illegal business practices that, according to recently filed litigation, allegedly took place at such homebuilders as Beazer and Ryland Group.

As *Business Week* (8/13/07) details, “Even as the housing supply began to exceed demand last year, builders kept sales brisk by pushing adjustable-rate, interest-only, and other risky loans. In some cases they attracted clientele who couldn’t afford conventional mortgages. In others, builders allegedly violated federal lending standards to get customers to sign on the dotted line.” It appears that shareholders, homebuyers, mortgage investors and warehouse lenders are among those already suing homebuilders and mortgage originators to recoup losses. For example:

- According to the *New York Law Journal*, individual borrowers are filing actions against brokers and loan originators under the TILA, HOEPA, RESPA, and state anti-predatory lending statutes. KB Home itself has already been sued at least once this year for RESPA and similar violations.
- In the wake of Beazer’s disclosure of criminal inquiries, shareholders filed a securities fraud class action lawsuit against the company. The company also faces at least two a putative homeowner class action lawsuits, one of which alleges executive officer and director breaches of fiduciary duty related to the company’s mortgage business.

- The Ryland Group faces a class-action lawsuit filed in June 2007 in federal court charging that the home builder required buyers to either use Ryland Mortgage Co. or pay several thousand dollars more for their homes.
- According to the *New York Law Journal*, warehouse lenders, who finance mortgage originators until a mortgage is sold to a permanent investor, have filed state breach of contract claims against the originators – at least 25 in New York alone – alleging that they failed to uphold their promise to repurchase early payment default loans.

C. KB Home's exposure to substantial legal and regulatory risk requires dedicated board capacity and focus.

KB Home has taken recent steps to address the inherent conflict created by its mortgage affiliate and enhance its legal and regulatory compliance. Specifically, the company sold its mortgage unit in 2005 to a joint venture operated by Countrywide, though it retains 50% ownership. It also disclosed in its 2007 proxy statement that the Board was creating the positions of Chief Compliance Officer and Risk Assessment Officer and, upon engagement of the former, would conduct a comprehensive review of its compliance environment. Responsibility for board oversight of legal and regulatory compliance, however, remains with the Audit and Compliance Committee, which is also responsible for the integrity of the company's financial statements.

This structure is simply inadequate to address the legal and regulatory environment the company now faces. In light of these risks, a dedicated Compliance Committee of independent directors is warranted. The purpose of the Compliance Committee would be to oversee the company's compliance with applicable legal and regulatory requirements (excluding securities laws and regulations, which would remain the responsibility of the Audit Committee). As an immediate first step, we ask that the Compliance Committee:

- Retain independent counsel to assist with the planned review of the company's legal and regulatory compliance status, placing particular emphasis on business practices involving its mortgage business and other affiliated business arrangements.
- Require the new Chief Compliance Officer, who shall report directly to the Committee, to work with the independent counsel and, based on the Committee's findings and recommendations, develop and implement a compliance program under the Committee's ongoing oversight.
- Work with the Audit Committee to develop enhanced financial disclosures relating to mortgage and other affiliated business arrangements to enable investors to evaluate the resulting legal and regulatory risk.
- Issue a report to shareholders with the Committee's findings and recommendations, and describing its compliance program.

Going forward, we believe the Board, informed by its comprehensive review, is in the best position to define the Compliance Committee's structure, duties and responsibilities. At a minimum, however, the Committee should:

- Consist of at least three directors, all of whom are independent.

Kenneth M. Jastrow, II

September 5, 2007

Page 5 of 5

- Meet at least four times per year, or more frequently as it deems necessary.
- Review management's implementation of KB Home's compliance program.
- Review with management, including the General Counsel and Chief Compliance Officer, the Company's relations with regulators or governmental agencies, and any significant legal, compliance or regulatory matters that have arisen.
- Inform the Audit Committee promptly of any matters that come to its attention that could affect the Audit Committee's responsibilities, including issues of financial disclosure.
- Retain independent legal, accounting, and other advisors as appropriate to assist the Committee in the discharge of its duties.
- Conduct investigations into matters relating to the company's legal and regulatory compliance as necessary.
- Issue a report to shareholders in the company's annual proxy statement, summarizing the Committee's meetings, risks identified and actions taken over the previous year.

We note that the above are generally consistent with the duties and responsibilities of dedicated compliance committees of other companies that face significant regulatory and litigation risk. In addition to Fannie Mae, for example, these include many health care (e.g. Express Scripts, HealthSouth and Sun Healthcare), insurance (e.g. AIG, AON, MetLife and Unum Group) and pharmaceutical (e.g. Medicis, Mylan and Watson Pharmaceuticals) companies.

D. Summary

KB Home is at a critical juncture. The collapse of the housing and mortgage markets has not only decimated its earnings and share price, it has also exposed the company and its shareholders to considerable legal, regulatory and reputation risk.

It is essential that the KB Home Board take proactive steps to mitigate these risks and protect the long-term interests of the corporation and its shareholders, most importantly by establishing a dedicated Compliance Committee to implement and oversee a robust program to detect and prevent material compliance failures.

Thank you for your consideration. We look forward to your prompt response.

Sincerely,



William Patterson
Executive Director

cc: Board of Directors