Secretary Henry Paulson
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

October 1, 2008

Secretary Paulson,

We are writing this letter, in the hopes that this document makes it into your hands. We are concerned about the financial health of our country, and so, we are being proactive as we feel we have a solution to the problem. The present plan has too many flaws and is too unpopular for most Americans. As a group of veteran Wall Street "fed-watchers", mortgage finance, and real estate experts, we believe we have unique insight and understanding and a plan that is digestible, workable, and sellable.

While we recognize that this looks like a liquidity crisis, at its core this is a crisis of trust. The capital markets are broken. Banks are too scared to lend to each other. Their concern and lack of trust stems from their inability to identify good banks from bad banks. The problem has to do with the identification and marking of illiquid Level 3 assets.

It is only when trust returns to the market will we be able to see the other side of this problem and return banking to some form of normalcy. Current plans and objectives need to focus on restoring TRUST in the lending markets. As Nietzsche once posited, "I'm not upset that you lied to me, I'm upset that from now on I can't believe you." All the money in the world will not trump trust, as we are finding out right now. Restoring interbank lending through restoring trust is a CRITICAL first step for a properly functioning economy.

FASB 157

There is absolutely no doubt that Wall Street will be drastically different going forward. Many are calling for a repeal of FASB 157. FASB 157 cannot be repealed. This rule is forcing banks to mark their Level 1, 2 and Level 3 asset positions "to the market". However enticing and difficult this procedure has been, retracting FASB 157 would only service to delay the evitable, encourage corporate lying and make us repeat the mistakes made by Japan with their unwillingness to address their non-performing loan problems. As you know, Japan ended up with a "lost-decade". Simply stated, retracting FASB 157 would reduce trust significantly.

- FASB 157 is a noble goal; one that is achievable and tackles a big problem head on. Compliance is essential, even if it means many weaker banks fail. The market is telling us that the banks need to be de-leveraged and transparency assured.

- FASB 157 has no doubt caused pain in the banking system. But let's remember, the pain originated from the poor decisions of bankers, and exacerbated further from the imprecision and lack of FASB 157 enforcement. Current strains are occurring from the resulting "good bank / bad bank" weeding out process. In such, now is the time to be even more resolute.

The process of restoring trust will certainly cause short-term pain and force some firms into bankruptcy. However, shoring up our banking system with inter-bank trust will make our banking system and the country stronger in the long run.

We have outlined and detailed below several actions that Washington can take to get us moving forward. If you like what you read in the proposal below, we would be grateful if you can ensure that the US Treasury see it. Thank you in advance for your assistance.

Sincerely,

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THE LEVEL 3 TREASURY DEFEASANCE PROGRAM

Background:
For a multitude of reasons, the inter-bank market has seized-up. Restoring faith in the balance sheets of banks will restore and stoke inter-bank lending and unclog all of the vitally important inter-bank markets. This plan provides the marketplace with bank balance sheets that they can trust; ones that accurately reflects Level 3 assets (or even under-values) through over collateralizing.

The Plan:
The "Level 3 Treasury Defeasance Program" calls for all Level 3 assets to be segregated on a banks balance sheet. Simultaneously, the US Government will attach non-interest bearing government issued Treasury Defeasance Bonds (called TDB's) directly to each individual Level 3 bond. The amount will be equal to the difference between their current mark-to-market ("high price"), and the "low" fire-sale price. By doing so, this will immediately snuff-out any valuation discrepancies (my 'mark' is more accurate than your 'mark'), and it will also give the banks time to realize each bonds true value. TDB's should not cost a dime. They will serve to fill any gap in an argument over real valuation of a Level 3 asset, and substitute that gap with a US Treasury TDB.

Example:
- A bank or financial company has Level 3 bonds (CMO's MBS's, CDO's) on their balance sheet.
- Assume the "fire sale" or "low" price of these Level 3 assets is .30 cents.
- The Treasury/Fed demands from the Level 3 holder, the exact quantity and Cusip #'s of their holdings, as well as their current "mark to market" (the "high" mark) for all Level 3 assets on their respective balance sheets.
- From this data, the Fed gets an average Level 3 "high" mark price for similar Level 3 bonds and securities. The Fed can bucket securities with certain similarities and make an assumption that the average "high" marks across all the banks, is .70 cents.
- The Treasury instructs each of these banks to then place these Level 3 bonds in a segregated area on their banks balance sheet called "LEVEL 3/TDB Holdings".
- The Fed then attaches a Treasury Defeasance Bond or TDB on each of these individual CMO, CDO, MBS L3 bonds, equal to the difference between their average or "high" mark to market of .70 cents, and the "fire sale" mark of .30 cents. In this example a TDB would be issued for .40 cents, and attached to each L3 bond in that segregated area of the balance sheet.
- These TDB's remain attached to each L3 bond as long as it stays on the banks balance sheet. TDB's are not transferable, or tradable; they are meant to restore faith in the balance sheets, not make a bad bond good.
- TDB's get handed back to the Fed the second a Level 3 bond trades off the balance sheet or matures. It is at this point when the firm recognizes a profit or loss, not when it is placed into the segregated account.
- All profit and loss pertaining to each of these Level 3 bonds stays with the banks giving them proper incentives.
- TDB's are not free. These guarantees will cost the banks an interest rate equal to the discount window rate. The interest paid for these TDB's will go toward operational costs and applied to the TDB losses, which only occur from bankruptcy liquidations.

Implementation of this program allows banks to trust their counterparty's balance sheet, because the ambiguities and inconsistencies of L3 marks are resolved. This solution gives banks financial incentives to both continue to write down the value of these Level 3 assets, and also the opportunity to trade out of these assets in the secondary market. The result would normalize libor spreads and reinitiate inter-bank lending.

Benefits:
- TDB's give the banks time to realize the assets true value without the pressure of forced liquidation or aggressive markdowns that could jeopardize their solvency.
- Politically sellable; shows leadership; restores trust; little if any cost.
- TDB's pay out only on Chapter 7/11 liquidation of the bank, and not on the default of the Level 3 bond.
- L3/TDB bonds can be repo'd with confidence of the money markets, opening up much needed financing for these bonds. The market rate for these repo's would be the equivalent of GSE / GC collateral, and the price of the repo will start at the "high" mark, and gradually descend toward the "low" mark in a straight line basis, over the life of the bond.
- Keeps the FASB 157 rules in effect. Strengthens the trust in the banking system. Builds a springboard for stronger balance sheets; future initiatives.
- Ensures that the banks have the necessary time for *their* valuations to come to fruition. No forced selling.
- Who better to manage these Level 3 bonds than the bank that purchased them?
- TDB's keeps these Level 3 assets off the Feds balance sheet.

- Allows Level 3 price discovery quickly, without the reverse auction cost potential. Banks that have already aggressively marked their Level 3 bonds down, can sell their Level 3 bonds in the open market for a profit or loss. When they do, they must immediately hand back the TDB on that particular bond to the Fed.
- Conversely, those banks that were slow to mark their Level 3 assets down in price have the luxury of time; can choose not to trade; can wait until the "market comes back"; or choose to mature their Level 3 bonds.
- Removes the incentive for arbitragers to "gang up" on the banks with heavy Level 3 exposure.
- Not applicable to future bond offerings, a "one off event" meant to restore balance sheets exposed to Level 3 assets.

Risks

- The number of TDB's needed is uncertain and could be as much as $3 trillion.
- Some of these Level 3 bonds at maturity could be worth zero, and that alone could bankrupt a few banks.
- Requires vigilant pressure from Fed and other regulators to pressure banks to work on their problems and write down their poor investments.
- Fed may need to decide what companies with excessive L3 assets are worth saving, and which ones are not because the risks are "too great".
- Repo market trade may be slow to develop.

2.) CENTRALIZE THE CLEARING OF ALL CREDIT DEFAULT SWAPS IMMEDIATELY

The Plan:

Declare IMMEDIATELY that all Credit Default Swap contracts must be traded on the Chicago Mercantile Exchange (CME) or another clearing exchange. The technology is there. Without being forced to adhere to this rule, the banks will not voluntarily move their current trades over to a centralized clearing system, because it reduces their ability to over-leverage these positions, it increases transparency, and most importantly, it drastically reduces the spreads that that provide them with considerable profits. Implementing this procedure is forward looking and addresses what could potentially be the next big crisis. It should be made mandatory and done immediately.

Background:

- The CDS market, which is estimated to be around $55 Trillion, is essentially a high stakes, high leverage casino game. Presently, these off balance sheet items do not show up in financial statements of institutions, banks or municipalities.
- Through this measure, the amount of open exposure on a particular stock, bond or security (called "open interest") will be disseminated to the marketplace. This reduces guessing about the amount of exposure in the marketplace, calms fears about counterparty risk, and ultimately becomes a self-regulating mechanism.
- Through this measure, all CDS transactions would be balanced and marked to the market every night by the exchange, eliminating the guesswork or fudging that comes with pricing these complex and un-standardized assets.
- Mis-marking of positions is snuffed out of the market place IMMEDIATELY and risk exposures identified.
- This requirement will reduce and identify the amount of short trading.
- This requirement would find broad support from the hedge funds, i.e., those who provide the most liquidity to the space. It will actually be supported by all participates, except of course, the market makers who will lose profits from a bid/ask spread that will decrease meaningfully.

Benefits:

- Attacks tomorrow's problems today with a no cost solution – it is a proactive remedy that must not be underestimated.
- If all CDS contracts are centrally cleared, the clearinghouse regulates the market. Capital is placed in margin accounts naturally reducing leveraged speculation, so there is no need to find out what exposures are held by individual banks.
- Cash placed as margin can be controlled by the exchange to "throttle back" the market if imbalances appear.
- The marketplace, through daily open interest releases, will know the total exposures and risk levels for CDS.
- Set expectations that all banks should be resolutely focused on the goal of disclosing all Level 3 and all CDS contracts in their annual reports and 10k quarterly financial reports. This is long overdue and rids the market of hidden leverage.
- This proposal is consistent with re-establishing inter-bank and consumer-to-bank trust, by eliminating off-balance sheet hidden costs.
- Takes a level of fear and uncertainty out of the municipal bond market.

Costs:

- Implementation has no cost to the taxpayer.
- It may be identify a few banks that are actually insolvent.
- A few Wall Street trading desks will lose the large bid /offer spreads that generate easy and real profits.

3.) THE COMMUNITY BANK LIQUIDITY PROGRAM

THE PLAN:

This solution proposes the Treasury put up to $75 billion into 5 year CD's (called "CMCD's") and allocated onto the balances sheets of the 8,333 community banks nationwide (average amounts to $9mm/bank). The Community Banks will be encouraged to lend the money to individuals and small businesses most in need. Traditional balance sheet lending will play a significant role going forward in cleaning up the mortgage mess. Community banks are healthy and typically do not own Credit Default Swaps, Sub Prime, CDO's CMO's. Furthermore, they have a vested interest in their communities, and can greatly assist the GSE's by re-financing existing mortgage loans in trouble (at reasonable rates and appropriate amounts) or by assisting individuals in purchasing homes now sitting vacant. This plan is politically sellable and will kill multiple birds with one stone. This program places decisions to the people closest to the problem and helps disperse the aggregated risks.

CMCD EXAMPLE:

1St Community Bank located on Main Street, USA receives $9,000,000 in cash from the US Treasury. The Treasury gets a 5-year CD or CMCD that pays a semi annual coupon to the US Treasury of 3.00%. The community bank than takes the $9mm and allocates $4,000,000 of it to fund the purchase of single family home loans for sale; $3,000,000 is allocated to make 5-yr fixed equipment and small business loans for their business customers; $2,000,000 is allocated to make 5-yr fixed consumer loans (auto's, school loans, etc) for individual customers of the bank. In addition, the bank can originate and sell x-1st mortgage loans to FNMA. This example could be for any amounts and allocated differently depending upon each respective banks customers need. Furthermore, the amount of lending can obviously exceed the $9 million injection as demonstrated in the next example.

Tier-1 Capital Effect Example

The average community bank today has a 10.8% capital/asset ratio as opposed to 7.5%-8% for NY Banks. A bank with $100 million in total assets would in this example have $10.8 million in capital ($10.8mm/$100mm= 10.8%). If this bank were to receive $9 million in CMCD deposits and make $9 million in loans, the capital ratio would fall to 9.91% ($10.8mm in capital/$109mm in total asset = 9.91%). The minimum capital /asset ratio to be deemed "well-capitalized" is 5%. Theoretically this $100 million bank could take on $20 million in additional deposits (and corresponding loans) and still have a 9% capital asset ratio, which is still well above the larger institutions.

BENEFITS

- Our proposed Community Bank solution is more than just an "insurance policy". It enlists thousands of strategic partners who can help disseminate risk, and kick-start the economy through responsible lending.
- Community banks have a vested interest to make sure their community is "fiscally fit".
- Our community bank solution is not a "bail-out" but rather an investment. The Treasury is already buying government securities for their own account. They can now buy CMCD's; money that will directly add liquidity to the Community Banking system.
- Our solution stimulates the economy, does not require congressional action, is quick and easy to implement and is disbursed to individuals and small businesses by way of 8,333 community banks skilled in lending in their communities.
- The community bank industry is well capitalized, well managed and adequately spread throughout the country. They understand that they are not "too big to fail" so they think carefully about the decisions they make. Most of these institutions are private, so it is the owner's capital at risk before anyone else (FDIC or taxpayer). If one of these banks fails, the owners are typically writing checks, as opposed to cashing checks like the executives of Wall Street firms. As a result, the free market discipline is alive and well.
- Community banks represent the only industry capable of immediately implementing such a "grass-roots" solution. A new government entity would take months or years to accomplish what community banks can do immediately.
- Community Banks are the only institutions that have demonstrated the common-sense to stay away from the very loans (sub-prime and other questionable mortgage loans) and derivatives that have caused the current problems. As a result, they can be trusted to make common-sense decisions.
- It will be local "experts" who will implement this "grass roots" solution. It acts to touch virtually every community in the US and gets the funds immediately to where it is needed most, i.e. to Main Street America (Individuals, Small Businesses, Farmers, etc).

- Assisting and adding capital to Community Banks avoids any Moral Hazard criticisms because it rewards those who were most responsible. These banks acted responsibly and avoided granting toxic loans such as option ARM's.
- Actually, it can be argued that the Community Banks were victims, taking deep loses from their investment in the devalued preferred shares of the GSE's. For the reasons stated above, they are the ideal partner in fixing the problem, and for helping to disseminate and disperse the risk.

RECOMMENDATION:

The Fed should, once again, raise the percentage ownership that outside investors can own in a commercial bank from the current 33% to 49%. This will encourage those with capital to invest in commercial banks, helping them to raise even more capital. Such a strategic partner could improve the quality of their capital base and potentially add assistance to their tier-1 capital requirements.

COMMUNITY BANK INFORMATION:

Community banks are defined as institutions with less than $10 Billion in total assets (most are less than $1Bln) and collectively have the following characteristics as of the FDIC's 6/30/08 call report.

- # of institutions – 8,333 (only 134 not "well-capitalized") – found on virtually every "main street" in America.
- Total Assets – $2.97 Trillion
- Total Capital - $321 Billion (10.8% of total assets)
- Total Loans - $2.1 Trillion (69.5% of total assets)

COSTS

- The plan has virtually no costs to the taxpayer. The purchase of community bank issued CDs, through the CMCD note structure, will be done by re-allocating a small % of dollars now being used to purchase Treasury Notes that various Government entities already purchase for their own account.
- Community banks pay the Treasury interest (a low rate but something).

RISKS

The risk to the taxpayer regarding this plan resides in the amount of loans that might eventually go bad as a result of the $75 Billion purchase of CMCD notes. However, this potential risk is shielded first by the participating banks individual capital and next by the FDIC Insurance Fund, which all banks support by way of their FDIC insurance fees. To protect the FDIC from their risks, the agency has implemented a significant amount of oversight, i.e. quarterly "Call Report" filings by all banks, annual on-site examinations and a mountain of regulatory regulations that relates to all bank activities.