**From:** Scott Clark [mailto:sclark@Virginiaheritagebank.com]
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**To:** LLPComments
**Subject:** Conceptual faults in the program design

Dear FDIC,

I listened to the conference call yesterday and I believe there are serious, and perhaps fatal, flaws in the program's conception, flaws that would lead to tremendous expense, and leave the FDIC (and the banking system) in worse shape than it might otherwise be in.

It seems there is an operating assumption that certain assets are not trading because their value is unknown. The FDIC intends to hold an auction and in that process the values will be discovered. OK. But you also purport that the FDIC will have underwriters (consultants and financial advisors) that will evaluate the asset pool, and determine the amount of debt (as a percentage) that the FDIC will offer to guarantee, and the interest rate that the FDIC will charge for the financing or the guarantee fee to be charged and this was described yesterday that it would be "risk-based pricing". The FDIC staff mentioned that they would do this and endeavor to charge a price that would cover any losses, so the program would be sustainable, and maybe a bit of a money loser as the admin costs would be charged to the Dept . of Treasury's account. OK. But if you could do that underwriting accurately, then you would de facto know the value of the asset pool (within a relatively narrow range of value at least). You'd have to know the value of the asset before you could be claiming to make a sound loan against it. In banking we use the language "the lesser of x% of the purchase price or appraised value", we have to protect ourselves from borrowers who might be overpaying for an asset and us thus overlending on an asset. If a FDIC analyst could get that math right, within the narrow band, then a private sector analyst could get that math right, and the value of the pools would be known, and no auction would be necessary. If the assets value is so volatile, so sensitive to various potential future conditions, that the price can be said to be unknown, or so uncertain, they should properly be purchased with all or mostly all equity, and the loans should be kept to a minimum.

Worse still, there is risk to the FDIC on both sides of that narrow band of value. If the bid prices are too low, banks may either choose not to sell and thereby keep the uncertain assets on their books, undermining confidence in those banks, or they may sell at the low prices and have to recognize losses on those assets which erode their capital base such that they become candidates for FDIC seizure and/or closure. But there is the problem that the price paid will be too high (why investors may bid to much will be explained below). If investors bid too high, the selling banks will come away relatively unscathed (at least for the moment), but the assets will prove to be of lower value than thought, and the investors and the Treas. Dept. will lose their equity investment and walk away (non-recourse), and the FDIC will be left holding the bag once again, that is with the assets right back in FDIC hands, where they would have been if the FDIC had just seized the bank and made its usual asset sales. The FDIC now faces the prospect of losing twice on the same asset.

We could all understand why bids might come in too low, but why would prices come in too high? My fear is that the answer is collusion amongst banks. You may be able to monitor the biding entities to have an arm's length distance from the selling entity, that would be tougher to monitor but it could be done. But if banks make special investment vehicles to make purchases at the auction, they might decide to make arrangements to swap bad assets of similar stripe, for inflated values, thereby cleaning their balance sheet at little loss, recognizing the loss in a SIV, and sticking the FDIC with ruins. If this happens, the special assessment to the DIF could limit the profitability of banks, leading to more candidates for FDIC seizure. There are other reasons, more innocent reasons, that bidders may pay too much, such as the financing terms being too generous, or just plain, old fashioned, unwarranted optimism. But in a case where a bank would come away relatively unscathed after using the program, but the investors lose and the FDIC losses big, there is no telling what kinds of indignation would spew forth from Congress that might propose to claw back the proceeds from the auction and make the bank take the loss anyhow.

There are also untold and unintended consequences in choosing among the types of auction procedures to be used, but I'll save that for another comment. I'll end this one by saying that this chosen path is fraught with unknown and uncharted peril. Why does the FDIC think that now is the time for bold, new experimentation in its operations and methods? Conceding that you need bold, new programs sends the signal that this is a crisis beyond our experience and that fuels more uncertainty and fear. You have tried and true methods. We have the lessons of the first half of the 1990s and the RTC. You can just do that but improved with the lessons learned from there. Banks might have bad assets that must be marked way down, but if they can survive the markdown from an auction sale, they can survive the markdown, and hold the marked down asset in a bad bank under their own holding company, if they can't survive it, well, somebody can, and will pick that up through the FDICs regular channels. In the early 90's that strategy worked for many, and real estate values can back quite nicely in '95, and '96 and beyond. It looks like all roads lead back to the FDIC, your goal should be liquidation at the minimum of expense, and this plan does not accomplish that. The expenses of manpower, consultants, auctioneers, etc. will be hefty. Please, please consider what I have written and scrap this plan. Using the standard methodology will signal that, while this is bad, we have a process for dealing with it, and we will get on with business as usual.

Thank you for your consideration.

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