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Attention Robert E Feldman
Executive Secretary
Federal Deposit Insurance Corporation
By email: LLPComments@FDIC.gov.

Submission: FDIC request for comment on the Legacy Loan Program

We are a start-up fund manager based in Australia. We also run a blog with many thousands of readers at brontecapital.blogspot.com.

We have in-house expertise in analysing defaulted and other questionable financial assets and considerable expertise in analysing banks and financial institutions.

We would have liked to participated as a principal in the Legacy Loan Program (LLP) funds however we do not meet the selection criteria as detailed by the Treasury.

We are however answering your call for submissions as to the nature and administration of the project.

We are available for further discussion if you wish.

<u>Goals of the project</u>

The request for submissions published on the FDIC website we believe is confused as to the goals of the LLP. For instance the request seeks to devise ways to encourage banks to sell the assets. However if the assets are correctly marked and the bank is sufficiently liquid we see very little policy reason why the bank should be encouraged to sell it.

We think that there are three ultimate goals of the LLP – two of which are stated (and we think indisputable) and one unstated (and which may be denied by the administration.

The undisputed goal of the LLP is to restore sufficient trust and funding into the American banking system so that it can resume its intermediation function and hence not exacerbate the current recession. We call this *the intermediation goal*.

The second indisputable goal of the LLP is to provide a basis by which liquidity is put into banks under severe stress. Rather than (say) having Citigroup come to the government and say “we need some liquidity”, Citigroup could elect to sell assets at market prices to the LLP funds and thus raise the liquidity. That makes the provision of liquidity to a bank in an emergency a market function and not a government fiat. We call this the *crisis liquidity goal*.

There is a third – unstated – goal of the program – which is to create a plausible market by which legacy assets can be marked or assessed. The creation of such a market gives regulators (ie you) the basis for questioning the marks in a bank’s book and hence for conducting assessments. That leaves you confiscating (or nationalising) banks like Washington Mutual based on a **real price for the assets** on their books rather than just some investment bankers asserting that WaMu is insolvent. We call this the *price discovery goal*.

The price discovery goal has not been stated by the administration but will provide the basis for the end solution to the banking crisis – proving through price discovery – that some banks are solvent and proving – also through price discovery – that some banks are insolvent. The government can use its FDIC liquidation powers to liquidate insolvent banks – or use TARP and other programs to recapitalise those banks.

With price discovery we can be assured that our shareholdings or debt holdings in banks are free from arbitrary government confiscation. This is a fundamental requirement for bringing trust back to the banking system.

<u>Outline of this submission</u>

We provide specific answers to the questions you asked in the call for submissions against the three criteria detailed above.

We also give one specific suggestion which we think would be useful – but is not necessary – in solving this financial crisis. That suggestion is about the staffing of the FDIC administrator.

<u>Answers to the specific questions</u>

1. Which asset categories should be eligible for sale through the LLP? Should the program initially focus only on legacy real estate assets or should any asset on bank balance sheets be eligible for sale? Are there specific portfolios where there would be more or less interest in selling through the LLP?

The answer to this depends on what the goal of the program is. If the goal of the program is to provide marks to questionable old assets on the books of banks then all (say) pre-June-2007 loans should be eligible. If the loans are particularly bad (evidenced by a low price) the government should be protected by only allowing a low level of leverage of the LLP funds.

Likewise – if the bank is in severe liquidity crisis – then also all pre-June-2007 assets should be eligible as the goal is to provide liquidity on a market basis not on a government fiat basis. Again the leverage level of the LLP funds should be very low as these assets are likely to be risky to the government.

If the goal is to provide price discovery then all loans should be allowed to be sold – but only in part. The banks should be allowed to sell say a 5% interest in the loans (less a modest servicing charge). A price discovery goal does not require sale of the asset – just that a price is determined.

2. Should the initial investors be permitted to pledge, sell or transfer their interests in the PPIF? If so, how should the FDIC ensure that subsequent investors meet the program's criteria for investors?

There are severe problems with allowing banks that sell the assets to PPIF to retain an interest in the PPIF. The conflict of interest between the two funds is overwhelming. There should be no way in which banks which are selling assets to the PPIF should be allowed to obtain an interest in those funds – and hence they should not be allowed to be pledged to the banks participating in the funds.

If third parties want to trade their interest in the PPIF amongst themselves there should be little difficulty provided that (a) genuinely conflicted parties are prohibited from obtaining an interest and (b) the control of the investments is retained within FDIC guidelines.

3. What is the appropriate percentage of government equity participation which will maximize returns for taxpayers while assuring integrity in the pricing by private investors? How would a higher investment percentage on the part of the government impact private investment in PPIFs? Should the amount of the government's investment depend on the type of portfolio?

This depends on the riskiness of the asset. Allowing two times leverage on assets trading at 30c in the dollar provides very considerable incentives for investors and still poses some risk to the government.

Eight times leverage should be acceptable for assets with low probability of default which trade at 95 cents in the dollar.

We suggest a sliding scale from 8 times leverage to 2 times leverage with the bounds set as above.

4. Is there any reason that investors' identities should not be made publicly available?

Normally we would say that there was no good reason why the identities of substantial investors and controllers of PPIF should not be made public. There are very substantial potential fraud and conflict of interest problems in the PPIF – and exposure is a very good control mechanism. In Australia idiom "sunlight is the best disinfectant".

However we live in a time when people threaten to strangle AIG executives with piano wire. Public safety probably (and unfortunately) precludes full exposure.

5. How can the FDIC best encourage a broad and diverse range of investment participation? How can the FDIC best structure the valuation and bidding process to motivate sellers to bring assets to the PPIF?

The FDIC could encourage a broad range of investor participation by drawing the selection criteria for eligible managers less narrowly. We would like to be included.

That said – allowing the interests to be transferable and even listed would be a good start. Apart from preventing the ownership of the PPIF instruments winding up in the hands of banks selling assets or other conflicted parties we see no reason why they should not be transferable.

The second question is – we think – absurd. There is no reason at all why banks should need motivation to bring assets PPIF. If the purpose is to restore trust then it does not matter if banks sell the assets – only that they can be *seen to do so*.

If the bank is suffering a severe liquidity event then they don't need a motivation to sell assets for cash. They will just do it or die. That is the "shotgun motivation".

If the job of the program is to provide market transparency may I suggest a third scheme – which is that banks be FORCED to put a randomly selected sample of assets up for sale but not be forced to accept the price received at the auction. The price received at the auction could however be used to mark the bank's book or to determine capital adequacy.

The PPIF need not be very big at all if its purpose is to provide market transparency. It may have to be enormous if its job is to provide liquidity.

6. What type of auction process facilitates the broadest investor participation? Should we require investors to bid on the entire equity stake of a PPIF, or should we allow investors to bid on partial stakes in a PPIF? If the latter, would a Dutch auction process or some other structure provide the best mechanism for bridging the potential gap between what investors might bid and recoverable value? If multiple investors are allowed to bid through a Dutch auction, or similar process, how should asset management control be determined?

No strong views.

7. What priorities (i.e., types of assets) should the FDIC consider in deciding which pools to set for the initial PPIF auctions?

If the job is to provide market transparency or trust the assets should be the ones with the widest bid-offer spreads in the market. The wider the spread the less people trust it. Narrowing the spread will allow a mark of the book and provide real advantages in trust and liquidity for banks.

8. What are the optimal size and characteristics of a pool for a PPIF?

We believe that there should be many pools (so they must be small enough to make that possible). Many pools will provide deep markets and hence more solid pricing for assets.

However many small pools may not provide a solution to a "Friday Night Liquidity Problem" for a major bank. A Friday Night Liquidity Problem will require a few very large pools to deal with.

So our suggestion is that there is NO optimal size for a PPIF pool – but rather a mix of sizes with some small, some medium and some large participants.

The range of size of participants is designed to meet the different objectives of the program.

9. What parameters of the note and its rate structure would be essential for a potential private capital investor to know at the time of the equity auction to provide equity?

This depends too much on the leverage rules – so we will leave the answer to this question to further discussion if you wish to have such discussion with us.

10. Would it be preferable for the selling bank to take a note from the PPIF in exchange for the pool of loans and other assets that it sells? Alternatively, what would be the advantages and disadvantages of structuring the program so that the PPIF issues debt publicly in order to pay cash to the selling bank? Would a public issuance of debt by the PPIF limit its flexibility compared to the issuance of a note to a selling bank?

No – under no circumstances should a bank be allowed to take a note from the PPIF in exchange for assets that it sells. The range of conflicts of interest in selling assets to funds in which you have an interest but which the government has provided leverage for is simply too large.

The conflict of interests just allow outsiders (myself and my blog included) to scream "potential fraud". Allowing such conflicts of interest will undermine trust in the system and undermine the whole program.

The whole program will achieve nothing if you allow selling banks to take notes from the PPIF.

Further the notes from the PPIF will not necessarily have a market price. Any price discovery goals of the program will thus be neutered.

We are genuinely surprised that this question has been asked and we seriously wonder whether staff of the FDIC are "on the take" (ie criminal) for even contemplating this. However we are – for the moment – simply concluding that the extent of conflict of interest involved is simply because the issues have not been thought through clearly.

We will not participate in any way in a program which allows this sort of conflict of interest. Indeed conflict of interest on this scale totally undermines the program.

11. In return for its guarantee of the debt of the PPIF, the FDIC will be paid an annual fee based on the amount of debt outstanding. Should the guarantee fee be adjusted based on the risk characteristics of the underlying pool or other criteria?

No – we do not believe the guarantee fee should be adjusted – just the amount of allowed leverage. See the above discussion.

Bluntly – asking for more money for the guarantee does not provide substantial protection for the government – but only changes their upside a little. Asking for more capital (ie lower leverage) does protect the government.

The government should be far more concerned about the capital levels of the PPIF than the fee for the guarantee.

12. Should the program include provisions under which the government would increase its participation in any investment returns that exceed a specified trigger level? If so, what would be the appropriate level and how should that participation be structured?

We have no view – however such provisions seriously undermine the motive for private sector involvement. They also increase the incentives for conflict of interest based fraud over genuine private sector investment.

13. Should the program permit multiple selling banks to pool assets for sale? If so, what constraints should be applied to such pooling arrangements? How can the PPIF structure equitably accommodate participation by smaller institutions? Under what process would proceeds be allocated to selling banks if they pool assets?

Given that one goal of the program is to solve the "Friday night liquidity problem" we see no alternative to allowing the banks to pool assets for sale.

Moreover the PPIF should be diversified as diversification reduces the risk to the Treasury of the program.

That said – single asset sales should be the norm.

14. What are the potential conflicts which could arise among LLP participants? What structural arrangements and safeguards should the FDIC put into place to address or mitigate those concerns?

This is the core problem that the Government faces. Suppose you hold $100 billion in bank debt. Suppose the bank is insolvent and has a lot of assets market at 80 which are in fact worth 20.

Suppose then you set up a fund with $8 billion of capital to buy those dodgy assets. The government nicely contributes another $8 billion from the TARP and the FDIC allows the $16 billion to be levered to over $100 billion. The $100 billion is used to buy the assets at 82. The bank is happy – it even booked a profit. The bank is now solvent.

The government is stuck with the losses – but the $100 billion in bank debt described above is made good.

The first group of people who should be prohibited from participating are those that already hold substantial interests in bank debt or bank stocks. This means that Pimco and Blackrock should be prohibited from participating.

The selection criteria drawn up by Treasury for the PPIF seem destined to maximise conflict of interest – and this undermines the program.

Likewise a bank selling assets to the PPIF should be prohibited from participating. The scope for fraud against the taxpayer is simply too large.

The main participants should be small non-conflicted fund managers. We would suggest ourselves – but acknowledge that it is unlikely you will draw the criteria that wide.

To us – the degree of conflict of interest that the FDIC seems willing to tolerate leaves us gobsmacked. We do not see how this conflict of interest furthers the major goal of the program which is to garner trust.

However allowing the highly conflicted to participate will allow the highly conflicted to bail out banks at taxpayer expense on a Friday night. If this is the goal of the program leave all the conflicts in place.

15. What should the relative role of the government and private sector be in the selection and oversight of asset managers? How can the FDIC most effectively

oversee asset management to protect the government's investment, while providing flexibility for working assets in a way which promotes profitability for both public and private investors?

There are an established set of bank rules – about leverage, capital adequacy and the like. The FDIC has long relied on auditors and bank inspectors to police those rules.

We suggest a similar process. Set the rules, and have auditors and bank inspectors. Give them teeth – but the main thing is to set the leverage rules appropriately.

16. How should on-going servicing requirements of underlying assets be sold to a PPIF and paid for? Should value be separately attributed to control of the servicing rights?

Selling the assets and transferring the servicing is clean – but transferring servicing can be expensive and difficult. Moreover there is little suggestion that the servicing of (say) Bank of America is poor. Indeed most the private servicers are deeply inferior to the banks servicing on their own account.

As a third party and small participant we would prefer if banks could sell assets and retain servicing – or sell a part interest in assets and retain servicing. The bank could keep the servicing assets on the book at a standard servicing right valuation – say one to one and a half percent of the serviced assets.

17. Should data used by the independent valuation consultant, as well as results of such consultant's analysis, be made available to potential bidders? Should it be made available to potential sellers prior to their decision to submit assets to bid?

Yes and yes. These are meant to be open auctions providing accurate pricing. The participants will all be financially sophisticated and will be able to provide

<u>The role of Sheila Bair</u>

Whilst you did not call for submissions on this issue we think that the goal of the PPIF – restoring funding trust in American banks – would be well served if Sheila Bair were to resign.

The problem is that the intermediate funders of American Banks have little trust. Banks cannot issue senior debt instruments. This is essentially the problem writ large. When banks can issue senior debt instruments at a reasonable price they can in turn lend and the macroeconomic crisis will be over.

There is a reason that banks cannot issue such instruments. The holders have been once-bitten – and they are twice shy. The takeover of Washington Mutual – clearly associated with Ms Bair – wiped out the senior holders for no consideration. This happened even though – by Ms Bair's own press release – WaMu was capital adequate on the date of solvency. This made the treatment of senior debt holders appear totally arbitrary.

If the senior holders had been converted to equity there is little doubt that Washington Mutual would be solvent – that would be equivalent to a $30 billion capital injection – more than sufficient to deal with Washington Mutual.

The lack of consideration to debt holders has put a climate of fear into US banks and that climate of fear is exacerbated by the continuance of Sheila Bair in her position.

We strongly submit that the entire program would be more successful if Sheila Bair were to resign. Sheila Bair is a symbol of arbitrary government action removing the rights of capital providers. There is no market solution whilst the fear of such arbitrary government action remains.

Thanks for your consideration

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