Legacy Loan Program

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What will be the return on investment to a private investor group who participates in the Legacy Loan program? This is a difficult question to answer without the assistance of a computer simulation model. In addition to answering the latter question I hope to enlighten the reader on some of the critical variables which will go into the determination of the success of such a program. In the formulation of this model I implicitly make some suggestions on the rules for the determination of the capital ratios for the loans granted by the FDIC and the priority of cash flow distribution throughout the life of a hypothetical investment program. I am the first to admit I have greatly simplified the complexity involved in such an undertaking ,however I believe that the reader will gain a great deal of insight into how the sensitivity of the many factors in the investment environment will affect the eventual outcome of the program. The best way to proceed would be to construct an example demonstrating the utility of the model.

Sole Investor Group Scenario

Critical Variables In a Mortgage Pool

Following the example in the White Paper describing the Legacy Loan Program on the FDIC website, let us say I bid $850 on a $1000 mortgage pool of loans having a 30 year term and an average coupon rate of 6%. Throughout the investment life of this pool of mortgages the success of my investment will be determined by :

1. The default incidence experienced on the pool-(5%)
2. The price I will receive from selling nonperforming mortgages in the open market (recovery price=20%)
3. The prepayment speed on the mortgages in the pool(6% per annum)

Given these assumptions I make a rough estimate of the annual cash flow and yield I can expect from buying this mortgage pool over the next 30 years(**cash flow yield=4%)** in the attached exhibit 1.

FDIC Loan –Treasury Partner –Investor Group Scenario

Now let us say my investment group participates in the Legacy Loan program by borrowing 84% of the cost of the pool($714) with a 3.5% loan from the FDIC and forming a 50-50 partnership($68-$68) with the U.S. Treasury.

Critical Variables

1. FDIC Capital Rule Requirement(annual loan to **book** value of assets=84%)
2. Treasury Equity Interest(50%)
3. Interest rate on FDIC Loan(3.5%)

Priority of Annual Cash Flow Distribution and Capital Ratio Requirements

1. Annual Cash flow from the pool of mortgages will first pay down the FDIC Loan to maintain an 84% capital ratio between the loan balance and the book value of the remaining loans in the pool at the end of each year
2. Remaining cash flow is split between the Treasury and Investor group(50-50)

Given these assumptions the return to my investor group is increased to 9%. Exhibit 1

Sensitivity of return To default incidence-FDIC Loan-Treasury Partner _Investor Group

It is interesting to note that if all the assumptions are the same as above with the exception that the default incidence on the pool increases from 5%-8% the return to the investor group becomes a -5%, highlighting the extreme sensitivity of the investment process to default incidence. **The investor would be wise to perform due diligence on the underlying credit characteristics of the participants in the mortgage pool.**