From: D Nowakowski [mailto:nowakows@hotmail.com]
Sent: Friday, April 10, 2009 1:26 PM
To: LLPComments
Subject: Legacy Loans Program

The FDIC has requested comments on its Legacy Loans Program (LLP). It is my strong belief that in addition to my personal views, several other commentator's analysis be added to the official record. In case the program turns out to be a failure and wastes or loses tremendous amounts of taxpayer money, our government and its officials should not be allowed the excuse that strong warnings were not issued.

Nobel Prize laureate Paul Krugman has argued that the program is simply a massive subsidy. In this case it would be simpler, faster, and more transparent to simply give money to the banks directly, for example buy their shares at 100 times the market price.
http://krugman.blogs.nytimes.com/2009/03/23/geithner-plan-arithmetic/

Columbia professor Jeffrey Sachs (along with the FT and other newspapers) has argued that the program is open to manipulation and corruption by investment bankers and lawyers. Past experience should confirm that these institutions and their lawyers are much cleverer than government officials and that whatever rules are put in place will be easily circumvented. The experience of Lehman quickly bundling toxic assets, getting rating agencies to stamp the senior tranches AAA, and extracting repo financing from the Fed, should be a glaring warning sign.
http://www.huffingtonpost.com/jeffrey-sachs/the-geithner-summers-plan_b_183499.html

Harvard and Princeton professors Coval, Jurek, and Stafford wrote a study arguing that investment grade credit spreads' widening "is highly consistent with the equity market's decline, volatility, and improved appreciation of risks embedded in structured products". This belies the entire case for what the FDIC and Treasury are doing, and thus suggests huge losses will be incurred by the LLP. As I'm sure the FDIC knows, the recent Congressional Oversight Panel's report also points out that there are many scenarios under which the current EESA approach is misguided. Finally, Willem Buiter is at the forefront of those arguing that the focus on financial institutions equity and assets ignores the real problem at the heart of this crisis: their giant liabilities. Allowing subordinated and senior unsecured debtholders to not suffer any consequence for their mistakes is not only unfair, but it will prolong and deepen the time that banks remain crippled and will need government subsidies like the LLP. On the other hand, even a small percentage haircut and debt-to-equity conversion could dramatically deleverage and recapitalize the financial system in one fell swoop.

My own comments on the specific LLP proposal are as follows:

1. The FDIC guarantee is a huge subsidy, proportional to the riskiness of each pool of assets. If the problem is honestly liquidity, then no risky asset that can result in a loss of more than 20% under an extreme stress scenario should be "wrapped". Individual assets that are risky can be included by pooling them with a large number of other risky assets, only if the correlation is low and the resulting pool's probability

of 20% loss is very small.

2. Agency risk suggests that buyers should not be allowed to flip the assets for a period of several years. This must include writing derivatives on the underlying assets; once again, be warned that the financial industry is extremely creative at skirting rules while staying within the letter of the law.

3. Government equity participation seems a red herring. The government can invest in the managed funds.

6. Auction theory is a complex field, with potential problems including, collusion, asymmetric information, and having too few bidders. It is very important to avoid overbidding, as the benefits will go to bank shareholders, and the losses to the FDIC and Treasury (along with investors). A descending auction, starting at par and coming down at 0.01% per second might be considered, with the first entrant to signal acceptance winning the bid. I would strongly urge contacting experts such as Oxford's Paul Klemperer, who has assisted governments in spectrum auctions in the 1990's and whose papers describe some spectacular auction disasters.

11. YES! The fact that the FDIC is even asking this question is disturbing. Formerly AAA securities, especially lower tranches, may now be effectively mezzanine and extremely risky. Even current ratings are probably garbage. The FDIC should charge the full value of its guarantee, integrating the possible loss over the ex-ante probability distribution of outcomes.

17. It would seem to me that this transparency would be useful to both buyers, sellers, and the public. The FDIC and treasury itself would also be able to assess the subsidy vs. liquidity premium issue, and when the latter disappears this program can be scaled back and eventually terminated or paused.

I sincerely hope these comments help the FDIC, and thank you for the chance to submit these thoughts. As someone who has had direct experience with many emerging market financial crises through my jobs in the financial industry, I know there is no perfect solution; as a patriotic citizen I hope that the FDIC is successful in its mission to safeguard the banking system while minimizing cost to taxpayers, except as specifically and expressly permitted by law. Good luck,

David T. Nowakowski
New York City, NY
h: 1-347-321-4940
m: 1-917-756-7732
