From: Steve Waldman [mailto:swaldman@mchange.com]
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To: LLPComments
Subject: LLP Comments -- Steve Waldman

Thank you for the opportunity to comment on the FDIC's "Legacy Loans Program".

I am Steve Randy Waldman. I blog frequently on financial matters at http://www.interfluidity.com/

I wish to state forthrightly that I believe that FDIC's participation in the Legacy Loans Program is illegitimate. The FDIC is an agency with a narrow and legally circumscribed mandate, from which it has deviated egregiously during the present financial crisis. FDIC's job is to monitor and regulate depository institutions whose liabilities the Corporation insures. The Corporation is both empowered and required to take prompt corrective action when the capital adequacy of banks is weak, under the principle of least-cost-resolution to taxpayers. FDIC has not even pretended to take the legal contours of its responsibilities seriously during the current crisis, and has behaved explicitly in the manner Congress intended to prevent when it passed FDICIA in 1991, putting off difficult problems and offering regulatory forbearance in a manner certain to lead to large taxpayer liabilities.

I do not believe there is any legal authority for FDIC to put its funds, ultimately guaranteed by taxpayers, at risk in ad hoc programs such as the Temporary Liquidity Guarantee Fund or the Legacy Loan Program. I do understand that you have lawyers and accountants at FDIC who have signed off on these programs. Enron had lawyers and accountants who signed off on their financial engineering schemes as well. That does not mean those schemes were either advisable or legal. During the present crisis, as it has become clear that a wide array banking industry practices has amounted to synthetic control fraud, the public has been told that nothing can be done to the malefactors. Specific practices were not illegal and therefore any remedies or punishment would be retroactive and unconscionable. Therefore, I wish to make it clear to the principals at FDIC ex ante that they are putting taxpayer resources at risk on a very large scale in a manner that many of us consider unlawfully beyond the scope of their discretion. If this results in large losses to the FDIC, vigorous investigation and potential prosecution of the individuals involved might well be warranted. The current managers of FDIC -- agents, in the end, of the United States taxpayer as well as thousands of small and prudently managed member banks -- do not have absolute discretion to put other people's money at risk on a massive scale, whether with the best or the worst of intentions.

I hope that FDIC will simply refrain from offering guarantees under the "Legacy Loans Program". If it does offer such guarantees, my strong advice is to do so under very conservative terms, consistent with the least-cost resolution principle. The legacy loans program is susceptible to gaming at the expense of taxpayers if private buyers and sellers collude, however tacitly and indirectly. I don't think it will be possible for FDIC to adequately police this, although of course it should try, for example by forbidding banks whose loans it is guaranteeing from bidding for or acquiring any assets that would be eligible for either the legacy assets or legacy securities program. FDIC should also do what no agency of the government has done thus far, which is to state unmistakably that collusion to overbid for assets whose value will ultimately backstopped by FDIC, Treasury, or the Fed constitutes fraud, that evidence of intentional overbidding will be vigorously investigated, and that perpetrators of overbidding schemes, however indirect, will be prosecuted.

Still, prohibitions of visible conflicts of interest and warnings of potential prosecution will be insufficient to prevent the gaming of these programs. Therefore FDIC will have to be vigilant about independently valuing each and every pool of assets it guarantees, and offering guarantees not up to the value determined by potentially compromised private bidders, but only up to FDIC's independent valuation of the asset less a haircut of at least 20% to ensure buyers have some real skin in the game. FDIC should err on the side of conservatism. It's primary goal should not be to "help the program succeed" by funding bids on assets that banks gladly accept, but to minimize (to very near zero), the net cost to FDIC of guarantees after its guarantee fee. FDIC is writing an option to the private participants in the legacy loans program. It should drive a hard bargain, insisting on being paid a premium at least commensurate with the risk it is bearing. If that means that many potential deals don't go through, so be it. FDIC is not empowered to resolve bank crises by engineering transfers by subterfuge from taxpayers or future guarantee premium payers to past malefactors.

FDIC should view its participation in LLP through a lens of "least cost resolution" narrowly, not "holistically". It might be tempting for FDIC officials to imagine that any excess costs borne by its participation in LLP serves to defray other eventual costs to FDIC from resolving weak banks. That is sloppy thinking, and indefensible. Each weak bank has its unique capital structure and problems, and the contours of any future resolutions, in terms for example of which uninsured liabilities might be guaranteed under a systemic risk exception, cannot be foreseen. Further, not all banks that participate in LLP are so weak as to require an exhaustive resolution. Wealth transfers from FDIC to already solvent banks are clearly additive to the eventual cost of resolving the present crisis, and should not be tolerated. Accounting matters, especially when hundreds of billions of dollars are put at risk. LLP should conscience no net wealth transfers from the public to private investors or banks. If, eventually, the public has to accept further losses in place of private banks and creditors, that should occur via a transparent and Congressionally approved mechanism.

On the pessimistic assumption that FDIC will not refrain from participating in the Legacy Loans Program, I will address a few of the specific question on which you have asked for comment:

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?

Absolutely not. As you point out, permitting transfers of interest in

PPIFs makes it easier for the actual bidders for a set of assets to disguise themselves, by having some other entity bid in their place. Further, PPIFs should be quite illiquid to the buyer in order to promote accurate valuation of assets. PPIFs should profit if they have accurately priced their purchases and bid reasonably, they should lose if they overbid. They should not have the option, so frequently exercised in the financial biz, of "putting lipstick on a pig" and selling out their interest to a less informed party. As much as possible, the actual agents responsible for purchasing PPIF assets should bear any costs, and reap any profits, that result from their pricing of the legacy assets.

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?

Government equity participation should be inversely related to FDIC's provision of a guarantee on non-recourse financing. The greater the leverage of FDIC guaranteed non-recourse financing, the greater the incentive on the part of private investors to collude with sellers at the expense of taxpayers. The government should only put up alongside equity on unlevered or very lightly purchases. Otherwise, the potential for taxpayers investing alongside a purchaser who intentionally overbids is simply too great.

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

Investors' identities should absolutely be made public, to discourage collusive gaming. All aspects of PPIF transactions, including the identity of buyers' and sellers, the financing terms, and the assets transferred, should be matters of public record.

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

The poor design of the program makes this a difficult question to answer. One goal of the program is price transparency, to enlist the skills of private experts at putting a not-liquidity-constrained expected value "legacy" bank assets. Determining expected values would be facilitated by making the asset pools as fine-grained and homogenous as possible. Homogenous and fine-grained pools will be subject to a much higher variance of outcome than highly diversified pools, and variance of outcomes increases the cost of FDIC guarantees even if the assets are accurately priced in expectation. Thus, price transparency and FDIC cost minimization are in direct tension. My view is that FDIC must make minimization of cost to taxpayers and innocent member banks its absolute priority, but it is unclear what pool size will in practice further that goal. Fine-grained pools ensure high guarantee payouts on accurately priced assets, while very diverse pools leave open the possibility of short-cut valuation heuristics leading to overpricing not detected by FDIC analysts. Unfortunately, this strikes me as an "anyway you look at it, taxpayers lose" proposition, because the program is so poorly designed.

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?

FDIC guaranteed notes should be issued to the selling bank by the PPIF, in order to help keep banks honest. If notes remain linked to the selling bank, it will be easy to compare eventual FDIC guarantee payments across banks as well as across PPIFs, in order to discern evidence of potential collusion ex post. There is no reason for PPIFs to issue FDIC guaranteed debt to the public.

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?

Yes. How is this even a reasonable question to ask? The FDIC is writing a put option to the PPIF, and the guarantee fee is the premium charged. Of course the premium of an option depends on the characteristics of the underlying assets.

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?

No. The identities of buyers and sellers should always be clear to discourage collusion and egregious mispricing. PPIFs can purchase separate assets from multiple banks. What FDIC can do is to guarantee pools of assets purchased from heterogenous banks post acquisition. There is no reason why the pools of assets that PPIFs can surrender to satisfy a set of loans needs to be the same pool transfered in a particular sales transaction. FDIC can permit PPIFs to purchase assets from smaller institutions, and combine multiple such purchases into all-or-none pools for guarantee purposes.

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?

Innumerably many. There is no set of fixed structural safeguards that could address these conflicts of interests. FDIC should put into place safeguards against easily foreseeable collusion, but must be ostentatiously prepared to investigate and prosecute arrangements that have the economic substance of collusive fraud, regardless of the specific form.

Thank you for the opportunity to comment.

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