From: Stephanie [mailto:Steph@fedupusa.org]
Sent: Friday, April 10, 2009 10:25 PM
To: LLPComments
Subject: Legacy Loans Program

I think all that needs to be said about this program was said recently by Institutional Risk Analytics, with which I agree entirely:

http://www.riskcenter.com/story.php?id=18155

April 7: Commentary - Apples and Truffles, PPIP is Financially Flawed, Intellectually Dishonest

Location: **New York**
Author: **IRA Staff**
Date: **Tuesday, April 7, 2009**

First, readers of The IRA who have not done so should read the most important commentary on the Madoff pyramid scandal yet, namely Woody Allen in *The New Yorker* in "Tales of Manhattan." "Two weeks ago, Abe Moscowitz dropped dead of a heart attack and was reincarnated as a lobster," Allen begins. Make sure you are not reading his rant while operating hazardous machinery, including walking along Lexington Avenue staring down at the Blackberry.

Now we consider the latest plan to rescue the large banks from toxic assets. This guest contribution to The IRA is made by a member of the Herbert Gold Society, an informal association of current and former employees of the Treasury and Federal Reserve System. Our earlier guest comment about fair value accounting ('What is the Stated Intent of Fair Value Accounting? Questions for Banks and Regulators', March 17, 2009) was made by another Herbert Gold Society member.

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Economists and market participants are coming to the realization that Treasury Secretary Timothy Geithner's "Public Private Investment Partnership" or "PPIP" is potentially a giveaway for some of the largest dealers and asset managers on Wall Street, and thereby tests the rule of law. In bare bones form, the PPIP is the purchase of toxic assets by the government and the simultaneous sale by the government of a five year call option on half the principle amount to the private players, this for a 3% premium (or half of the total implied option value of 6%). This is also known as the private "equity" stake.

But all of the detail of the PPIP -- the non-recourse loans, guarantees by the FDIC, the funding by the Fed and the auction -- are mere devices, canards that obscure the true structure and purpose of the PPIP, namely doing nothing in ever more complex ways.

To that point, consider a question: Is this "new" plan an improvement over the original TARP which failed because of the absence of any mechanism (in the absence of a market) to determine a fair price for the toxic assets?

To us, the answer is no. And along with Geithner, we must hold Larry Summers responsible for approving this inaction, this very expensive non-solution.

The plan as presented simply replaces the current problem with a more complex, subsidized shell game meant to hide the same problem. It fails in the key goal of setting cash market prices for the underlying assets for which there is no current liquid market. But this problem is as nothing compared to the task of setting a price on a call option on assets for which there is no current market, observable price or price history on which to estimate the either historical or implied volatility.

The private sector participation, aka the "premium," as set by the Treasury, will be at least as arbitrary as any price for the underlying assets that might have been imposed as part of the original TARP. The PPIP compounds the fatal problem with the original TARP, but is presented as the solution to the problem.

The auction process in the PPIP will attach a price to the toxic assets, but it is a price predicated upon the fact that private side is bidding for the upside only. The auction prices are based on the private side paying a 3% premium for the implied five year called option. Is the 3% premium a fair price for a five year 50% participation in the upside for assets whose prices have been as volatile as those of the underlying toxic assets?

Again, the answer is no, or at least very, very likely, to be no.

There is no market for options on the toxic real estate assets of banks per se, but there are options on REITS. REITs are not bank owned toxic real estate assets, but they are real estate pass throughs and have had their prices marked down much as value of the toxic real estate assets of banks.

The "junk" and beyond nature of some of toxic assets also suggests that they would trade more like equities than fixed income instruments. A quick and unscientific survey of near the money 6 month options on REITs reveals implied volatilities in the neighborhood of 80% and prices near 15%: That's 15% for 6 months versus 6% (adjusted to reflect the full, 100% of the upside in the PPIP deal) for 5 years.

The comparison is clearly between apples and oranges, but prices suggest a comparison between apples and truffles. There are numerous questions which would have to be answered before a fair comparison could be made, but it is unlikely that any option pricing routine using reasonable estimates for volatility will produce a premium of 6% for a five year option on troubled real estate assets. We suggest that readers use whatever method they chose to devise or estimate a realistic range of prices for the option and the transfer subsidy from the US taxpayer implied in the 3% premium.

One additional possible problem in pricing the implied call option is the "moneyness." Let's assume that the auction price will be the "strike" price, but the auction price is contingent on the existence of the option. It is logically inconsistent to call the auction price a market price, when is determined by an off-market option price, but this is the result of setting a fixed option premium without knowing the market price. Is the auction price the true spot price when similar assets not included in the PPIP are selling at discounts to the auction price?

Market participants ought to put themselves in the shoes of a customer who makes the following request from an option market maker: Call up a major dealer and say that we want:

1. A call option;
2. Multi-year tenor;
3. At an unspecified date in the future;
4. For very large but unspecified amount (hundred of $Billions) of an unspecified asset (Levels 2 and 3) mix;
5. On recently very volatile assets;
6. Struck at an at the money-limited-auction-price, but identical assets are carried on financial institutions balance sheets below the auction/strike price;
7. The option seller must agree not to hedge his position;
8. The option buyer agrees not sell the underlying assets, but sister entities can presumably cross hedge at will;

9. By the way, the vol history is effectively none existent:
10. And the premium must be fixed today at 3%

Is there any question about what the market maker's response would be? Does "Foxtrot Oscar" ring a bell?

The difficulties in determining a price for the call reinforce the point made earlier: the PPIP simply replaces the problem in the original TARP with a more complex and difficult problem. This all suggests that the goal of the PPIP is not price discovery, but creating an artificial price and generating fees for the dealer and asset management community.

To the extent that the 3% premium for the 50% share of the implied call is too low, it suggests a subsidy to the private players in the PPIP. How large a subsidy? It is difficult to say given the difficulties in estimating a fair price for the option. This subsidy would be in addition to any subsidy supplied via below market financing of the PPIP.

Why the complicated structure? Innocent answer: Treasury is unwilling/afraid to ask the Congress for the funds or authority to write a covered call or otherwise unwind the mess. A more cynical view is that complexity is designed to disguise the fact the PPIP requires Federal agencies to take steps well beyond their mandates. The FDIC is called upon to provide option protection to a de novo Treasury created quasi public entity - call it a Geithner/Summers SIV - which is a far cry from providing deposit insurance in return for insurance premiums or liquidating failed bank assets.

The Fed is called upon to provide financing not for a solvent bank and based upon good collateral or for systemically important firm, but for a Treasury created and sponsored entity. The result of these actions is the writing of a covered call option, when none of the above agencies is authorized to write options. The plan clearly tests the rule of law, but Congress will not protest and reserve its option to protest and change the terms ex post.

Flaws and dishonesty notwithstanding, we expect that the PPIP with only minor changes to become operational - unless the building angst in the Congress boils over sufficient to change the course of the Summers/Geithner large bank giveaway. There is too much political capital invested in it for the proponents to walk away, we are told, but the irony is that the changes to the fair-value-accounting rule last week may now make many banks reluctant to participate.

The PPIP is potentially a subsidy for a variety of financial institutions, many of whom have been seen in the markets buying toxic waste at 30 cents so that they may sell it to Tim Geithner's Treasury at 80 cents. Some large bank CEOs will protest being "forced" to sell assets, but they will eventually rollover rather than be "Rick Wagonered" by Geithner et al. But the big payoff could be for the likes of our friends at PIMCO, Blackrock (NYSE:BLK) and the other asset managers who will be called upon to maintain this floating superfund site.

When General Motors (NYSE:GM) is forced into an inevitable bankruptcy this June, however, doing similar for American International Group (NYSE:AIG) and the large banks will become a political inevitability and the notion of storing toxic waste will be shown to be a truly harebrained idea. As the Obama Administration begins to understand how deep the rabbit hole does indeed go in terms of subsidizing the continued existence of the growing collection of zombie financials, liquidation will become the most popular topic in Washington.

The tragedy is that the time lost between now and when the President realizes he is getting bad advice from Summers & Geithner could be the difference between a very bad recession and a crippling meltdown that is, in part, made worse by a PPIP that represents virtually no change from previous policy.

This program is nothing more than another way to provide banks the opportunity to commit theft of taxpayer money, with aid from our government.

Sincerely,

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