From: Linus Wilson [mailto:linuswilson@yahoo.com]
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To: LLPComments
Subject: Legacy Loans Program

April 10, 2009

To Whom It May Concern:

My academic research leads me to have several concerns about the effectiveness and potential cost of the Legacy Loans Program that has been proposed. I have numbered these concerns below:

1. My paper "The Put Problem with Buying Toxic Assets" at http://ssrn.com/abstract=1343625 suggests that the gap between the price at which banks are willing to sell toxic assets and the price at which the private sector is willing to buy toxic assets may be large. The bid-ask spread will be larger for banks that are more insolvent. It will also be larger for banks that have more distressed or volatile toxic assets. My research shows that it is much better to buy toxic assets from troubled banks after troubled banks have entered a regime similar to receivership than before those bad assets are written down.
2. I fear that under the current proposal that the only banks that will sell toxic assets will be well capitalized. Well capitalized banks are less likely to have improved lending if they dispose of their distressed legacy loans. Only banks that are insolvent or are experiencing financial distress will see improved operating decisions and better lending incentives if they reduce the volatility of their assets. If this is the case, then U.S. taxpayers will bear the risk of huge losses without improving the incentives in troubled banks.
3. A toxic asset purchase program such as the Legacy Loans Program will only encourage banks to make good loans if banks are prevented by their regulators from purchasing speculative loans from other institutions after they sell their legacy loans.
4. I have a couple of working papers that ask whether purchases of toxic assets, purchases of preferred stock, or purchases of common stock are more efficient *ex post* and *ex ante* for banks that regulators believe are "too-big-to-fail." My paper "Debt Overhang and Bank Bailouts" online at http://ssrn.com/abstract=1336288, does argue that common stock infusions and toxic asset purchase are equally efficient in improving lending incentives. However, the current draft assumes that the transaction costs of purchasing toxic assets and purchasing common stocks will be the same. That current draft assumes that only the bank selling the securities will receive subsidies. It seems likely in the proposed design of the Legacy Loans Program that some subsidies from the nonrecourse loans will flow to the private investors. If both the bank and the private investors are receiving sizable subsidies under a toxic asset purchase, then that means that common stock purchases are more efficient *ex post* and *ex ante*. None of the benefits from buying common stock in my research comes from exercising control rights. Thus, if the government does buy common stock in a distressed but not yet insolvent bank, it could sell its stake immediately to third party investors and the troubled banks' lending incentives would improve.
5. It also makes little sense for regulators to allow large banks such as the 19 banks receiving stress tests to be buyers in the Legacy Loans Program. Allowing large banks to buy toxic assets with FDIC guaranteed nonrecourse loans increases the risk that those institutions will be insolvent or distressed in the future.
6. Banks should not be allowed to bid on their own legacy loans. Otherwise, they may be tempted to grossly overbid and pass losses onto taxpayers. (I believe that this is explicitly prohibited in the term sheet.)

7. It makes little sense for regulators to allow private investors to buy legacy loans from smaller banks which pose no systematic risk. If smaller banks are distressed or insolvent, it is more efficient for the FDIC to exercise prompt corrective action and restructure them in receivership.

Thank you for considering my comments. Feel free to contact me if you have any questions.

Sincerely,

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