From: Robert Smith [mailto:smith_rob@yahoo.com]
Sent: Friday, April 10, 2009 10:46 PM
To: LLPComments
Subject: Legacy Loans Program

Dear FDIC

The whole concept behind the Legacy Loans Program is flawed. The argument is that the market for these assets isn't a true market; that these assets are being bid at fire sale prices; that the value at which these assets are being marked by banks is more reflective of their true value.

However, when it comes to mortgage assets, and securities derived from them, determining value is a difficult proposition. Banks will try to value these assets using discounted cash flow models, but ultimately, the value will be driven primarily by the loss estimate.

Likewise, when an investor is bidding on these assets, they are also valuing the assets using a discounted cash flow model, and their value is likewise dependent on loss estimates.

So, two different parties valuing the same assets using the same fundamental technique, resulting in two vastly different values. What gives?

The problem is estimating those losses. When it comes to modeling mortgage losses, the challenge ultimately comes down to estimating human behavior. With any borrower in any given situation, you need to estimate both their willingness and ability to make their mortgage payments. In today's environment, this is extremely difficult, if not impossible, something you should know through your IndyMac experience, where you initially estimated you would lose between $4 - 8 billion, and ended up losing $10.7BB.

The ability to pay is difficult enough to estimate. The vast majority of loans originated in the past few years were underwritten without documenting income or assets. That includes, by the way, most of the mortgages guaranteed by Fannie and Freddie. I have seen some estimates that up to 70% of DU and LP approvals were given documentation waivers, a percentage in line with the private label market.

So the true ability of the borrower to pay in normal circumstances is unknown, since you don't know their income. In an environment with increasing job losses, the problem gets really tough, because you also don't know what level of true reserves they started with. To put it simply, you don't know the borrower.

Estimating the willingness of borrowers to pay is, quite frankly, nearly impossible, because we have never had an event where a large population of borrowers is underwater.

Traditionally, the willingness of borrowers to pay their mortgage is estimated by the borrower's original and updated LTV. The thought is, a borrower who initially puts their own equity into a property, and either maintains that equity or increases it through

property value appreciation, will have an incentive to pay their mortgage proportional to the equity level.

Borrowers who put down 30% are more likely to pay than those who put down 25%, those who put down 25% are more likely to pay than those who put down 20%, etc. Even if those borrowers become underwater on their mortgages, they may feel some reluctance to walk away from their money, on the hope that their investment may rebound.

(The amount of equity does also affect the ability to pay in a small way, as a borrower can tap equity to pay their monthly mortgage payment, sort of like borrower against your credit card to pay another card).

But what is the willingness to pay of a borrower who put no equity into their property, and are underwater by 10%, 20%, or more?

No one knows, and anyone who says they know is wrong. There is simply not enough experience in U.S. history to determine how these borrowers will perform.

Other markets have experienced similar situations (e.g. Hong Kong in the early 2000s), but never has there been such a massive population of borrowers with negative equity, with non-recourse mortgages, access to resources to help them "walk away", and a shrinking social stigma to defaulting on debt.

Given that some estimates are that upwards of 9 million homeowners are underwater, how will they all react? Will 20% of them walk away? 30%? 75%? No one knows, they can only guess.

If you were an investor looking to acquire these assets, you would most likely take a more conservative view on the ultimate performance of these assets, and/or increase your hurdle rate to compensate for the uncertainty, which would lead to a lower bid price.

On the other hand, if you are a bank, you would be more inclined to extrapolate historical performance to current loans, and discount the cash flows at your cost of capital, resulting in a higher value.

The gap in value has little to do with the availability of leverage, as you appear to claim. It is an issue of two different approaches to valuing uncertainty.

If an investor approached a lender to debt-finance these purchases, the lender would need to charge a high interest rate in order to compensate for their uncertainty, since they are effectively selling a put option on an asset with very high uncertainty. The cost of the debt would lead the investor to bid essentially the same price as without debt - there is no free lunch.

What I am afraid of is you, who are effectively backed by me, the taxpayer, will subsidize these purchases with underpriced debt, by not charging an adequate interest rate to compensate for the risk.

If I were in charge of my own tax dollars, and was forced to lend against these assets, I would charge an interest rate well into the double digits. If you charge anything less I will really question the integrity of this program.

Rob Smith