From: Rolfe Winkler [mailto:rolfe.winkler@gmail.com]
Sent: Wednesday, April 01, 2009 11:16 AM
To: LLPComments
Subject: Legacy Loans Program

To Whom it may concern:

I write to urge you NOT to institute the Legacy Loans program as part of Treasury Secretary Geithner's plan to resurrect the banking sector. No doubt you've heard many arguments regarding the perverse incentives created by such a program. Providing non-recourse financing to fund these purchases will encourage financial institutions that face further writedowns, or creditors who would bear the consequences of them, to effect a transfer of risk from bank balance sheets to the public's. They sacrifice a sliver of equity in order to trade "toxic assets" for government-backed assets. A great deal.

No doubt FDIC recognizes these conflicts of interest, and is put off by them. I'm sure you wouldn't be instituting the Legacy Loans Program if you didn't think your hand was being forced: If you don't rescue the banks, they will become the responsibility of the very-much-depleted Deposit Insurance Fund. Better to provide government guarantees on assets in order to avoid that outcome. **But government guarantees won't avoid that outcome. The financial system will fail anyway and FDIC will have wasted precious resources that could have been used to clean up the mess.**

Pumping more credit into the market to artificially inflate asset prices does nothing to repair the fundamental value of the underlying collateral. It's well-known that house prices got "too high" because their values during the bubble had, by too-cheap credit, been totally divorced from people's incomes. Few could actually afford their over-priced houses based on their earnings potential; no, they levered up using cheap, non-recourse financing to buy an option on further appreciation. The banks were stupid enough to sell buyers these options because they deluded themselves into believing house prices never go down. And because they paid their bankers based on loan production, not loan quality.

But of course asset prices can go down. Even in this Age of Leverage, there was a limit to the amount of credit that banks could manufacture on and off their balance sheets. When credit dried up, asset prices had no choice but to return to more fundamentally sound levels, which is to say, prices that can be supported by buyers' incomes.

FDIC's plan to provide subsidized financing in order to prop up asset values puts taxpayers in the position once occupied by irresponsible bankers: we are lending at too-low interest rates to subsidize the purchase of overvalued assets.

Again, you probably recognize this to be foolish, yet you believe it is a better alternative than having to deal with failed banks via the receivership process typically imposed by FDIC. Where I fear you are terribly mistaken is your belief that this plan will avoid that outcome.

Let's say this plan succeeds in cleansing banks of their toxic assets. What then? They're likely to start lending again, which, contrary to popular opinion, is exactly what we DON'T want to happen. It was after all, too much credit that inflated the bubble in the first place. Does the government honestly believe that re-inflating the bubble is the solution to this economic crisis? American society is now largely bankrupt because we have run up debts that are simply unpayable. What is the merit in manufacturing still more debt to artificially re-inflate asset prices?

My point is that de-leveraging can't be avoided. Asset prices can't, by too cheap credit, be permanently divorced from the cash flows they are capable of generating. Runaway speculation on ALL assets financed with credit has led to the accumulation of so much debt, there's simply no way to pay it all back. Much has to be written off.

Yes, this wave of writedowns looks scary, like a tsunami about to wash over the world's financial system. But Geithner's plan can't stop it; it is tantamount to building a bigger sand castle in order to hold the tsunami at bay.

It makes no sense to waste the public's meager resources on a plan that solves nothing. The unwind is coming. Adding more leverage to delay it will only increase the pain.

Sincerely,

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