

Exposing Corruption Exploring Solutions
Project On Government Oversight

April 10, 2009

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 20429

Dear Mr. Feldman,

The Project On Government Oversight (POGO) appreciates the opportunity to submit a public comment on the Federal Deposit Insurance Corporation's (FDIC) proposed Legacy Loans Program (LLP). POGO is an independent nonprofit that investigates corruption and other misconduct in order to achieve a more effective, accountable, open, and ethical federal government. Although POGO takes no position on the strategic merits of the proposed LLP, we feel compelled to oppose the program based on a number of serious concerns that have been raised about its legality and about the lack of adequate measures in place to protect taxpayers from waste, fraud, and abuse.

Concerns About the Legality of the FDIC's Participation in the LLP

The FDIC was originally established to insure deposits, examine banks, and act as a receiver for failed banks.¹ Upon reviewing the FDIC's statute under the Federal Deposit Insurance Act (FDIA) and the terms of the proposed LLP, we are deeply concerned that the FDIC is exceeding its mission and acting outside of its authority by participating in the program.

Under the proposed terms of the LLP, the FDIC will guarantee the principal amount of the non-recourse debt issued by public-private investment funds (PPIFs) to finance up to 85% of the purchase price of toxic assets acquired from banks and other financial institutions. Ultimately, the FDIC may guarantee up to \$1 trillion or more of loans made to the PPIFs.²

Similar to the loans and guarantees recently issued by the Federal Reserve as part of the government's effort to stabilize the financial system, the FDIC-guaranteed financing under the LLP has not been authorized or appropriated by Congress. In a recent CNBC article, Rep. Brad Sherman (D-CA) called such financing "an end-run around

¹ Federal Deposit Insurance Corporation. "FDIC Mission, Vision, and Values."
<http://www.fdic.gov/about/mission/index.html> (Downloaded April 10, 2009)

² Federal Deposit Insurance Corporation. "Fact Sheet: Public-Private Investment Program."
<http://www.fdic.gov/llp/LLPtermsheet.pdf> (Downloaded April 10, 2009)

Democracy” and noted that “no one even imagined we would see trillions of dollars shifted from Washington to Wall Street that no member of Congress ever voted for,” a concern echoed by numerous commentators in recent weeks.³

It is our understanding that the FDIC is participating in the LLP under the emergency systemic risk exemption set forth in Section 13(c)(4)(G) of the FDIA, which allows the FDIC to take extraordinary measures to assist an individual institution whose collapse would have “serious adverse effects on economic conditions or financial stability”.⁴ However, it appears to be an enormous leap to go from that to potentially subsidizing the purchase of assets from multiple institutions, including well capitalized institutions that are not in imminent danger of failing, as the FDIC proposes.

In addition, the FDIC’s financial obligations under the LLP should be limited by other provisions in its charter. In particular, under Section 15(c)(5) of the Act, the FDIC is not permitted to incur aggregate obligations in excess of the sum of (a) the amount of cash or cash equivalents held by the Deposit Insurance Fund, plus (b) 90% of the FDIC’s estimate of the fair market value of assets held by the Deposit Insurance Fund, other than assets described in (a) above, plus (c) the total amount the FDIC is authorized to borrow from the U.S. Treasury.⁵

Based on the Deposit Insurance Fund’s (DIF) latest financials,⁶ the DIF has a balance of \$19 billion and is authorized to borrow approximately \$30 billion from the U.S. Treasury.⁷ This means that the FDIC would be prohibited from having more than \$49 billion of obligations under Section 15(c) of the Act. Currently, the FDIC has debt guarantees of \$268 billion under the Temporary Liquidity Guarantee Program,⁸ which is already many multiples in excess of the FDIC’s statutory limitation.⁹

³ Albert Bozzo. “Obama’s Toxic-Asset Plan: End-Run Around Congress?” CNBC. March 25, 2009. <http://www.cnbc.com/id/29863145> (Downloaded April 10, 2009); Tyler Cowen. “The Geithner Plan: An End Run Around Congress.” *CBS MoneyWatch*. April 8, 2009. <http://moneywatch.bnet.com/economic-news/blog/blog-war/the-geithner-plan-an-end-run-around-congress/209/> (Downloaded April 10, 2009); and John P. Hussman, Ph.D. “On the Urgency of Restructuring Bank and Mortgage Debt, and of Abandoning Toxic Asset Purchases.” Hussman Funds. March 30, 2009. <http://www.hussmanfunds.com/wmc/wmc090330.htm> (April 10, 2009)

⁴ Federal Deposit Insurance Corporation. “FDIC Law, Regulations, Related Acts – Federal Deposit Insurance Act.” <http://www.fdic.gov/regulations/laws/rules/1000-1500.html#1000sec.13c> (Downloaded April 10, 2009)

⁵ Federal Deposit Insurance Corporation. “FDIC Law, Regulations, Related Acts – Federal Deposit Insurance Act.” <http://www.fdic.gov/regulations/laws/rules/1000-1700.html#1000sec.15c> (Downloaded April 10, 2009)

⁶ Federal Deposit Insurance Corporation. “Deposit Insurance Fund Trends: Fourth Quarter 2008.” <http://www2.fdic.gov/qbp/2008dec/qbpdep.html> (Downloaded April 10, 2009)

⁷ Federal Deposit Insurance Corporation. “FDIC Law, Regulations, Related Acts – Federal Deposit Insurance Act.” <http://www.fdic.gov/regulations/laws/rules/1000-1600.html#1000sec.14a> (Downloaded April 10, 2009)

⁸ Federal deposit Insurance Corporation. “Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program.” February 28, 2009. http://www.fdic.gov/regulations/resources/TLGP/total_issuance2-09.html (Downloaded April 10, 2009)

⁹ This also assumes that the FDIC will not incur any additional obligations in connection with the failure of a bank. Over 20 banks have already failed already this year, and it is highly likely that others will follow.

Given its statutory limitation, we are unclear how the FDIC can propose to issue additional guarantees on up to \$1 trillion of loans to the PPIFs as required by the LLP. According to a recent *New York Times* column, the FDIC is circumventing the restrictions on its financial obligations by categorizing these guarantees as “contingent liabilities.” By this logic, as long as the FDIC doesn’t expect a loss, it has unlimited authority to issue guarantees. And as stated in the *Times* column, the FDIC asserts that “[its] accountants have signed off on no net losses.”¹⁰

The FDIC’s assertions can be challenged on two fronts. First, many observers have commented that the whole point of the PPIFs is to subsidize the purchase of assets at inflated prices.¹¹ As a result, there is an increased likelihood that the FDIC will incur significant losses. A lender who lends for the purpose of sponsoring the purchase of assets at above market prices is simply asking for losses. Should the various programs to prop up prices ultimately fail, the losses will prove to be highly correlated and could reach massive sums.

Second, according to its own statute, it seems inaccurate for the FDIC to claim that its obligations under the LLP are contingent liabilities. Section 15(c)(6) of the FDIA defines “obligation” to include any guarantee issued by the FDIC, other than deposit guarantees.¹² It would appear, therefore, that guarantees or loans issued by the FDIC to the PPIFs must be included in the calculation of the FDIC’s obligations at their notional amounts, rather than being categorized as contingent liabilities.¹³

Therefore, the FDIC’s central role in the LLP violates the intent, if not the letter, of its statute. Despite Congress’s clear attempt to limit its exposure to the amounts set forth in Section 15(c)(5) of the FDIA, the FDIC’s unreasonable interpretation leaves the taxpayer at risk for hundreds of billions and possibly more than \$1 trillion. We find it hard to believe that Congress intended to delegate this authority in the manner the FDIC asserts.

¹⁰ Andrew Ross Sorkin. “‘No-Risk’ Insurance at F.D.I.C.” *The New York Times*. April 6, 2009. <http://www.nytimes.com/2009/04/07/business/07sorkin.html> (Downloaded April 10, 2009)

¹¹ See for example: Laurence J. Kotlikoff and Jeffrey Sachs. “The Geithner-Summers Plan Is Worse Than You Think.” *RGE Monitor*. April 6, 2009. http://www.rgemonitor.com/financemarkets-monitor/256301/the_geithner-summers_plan_is_worse_than_you_think (Downloaded April 10, 2009); Joseph E. Stiglitz. “Obama’s Ersatz Capitalism.” *The New York Times*. March 31, 2009. <http://www.nytimes.com/2009/04/01/opinion/01stiglitz.html> (Downloaded April 10, 2009); and Jeffrey Sachs. “Obama’s Bank Plan Could rob the Taxpayer.” *Financial Times*. March 25, 2009. <http://www.ft.com/cms/s/0/b3e99880-1991-11de-9d34-0000779fd2ac.html> (Downloaded April 10, 2009)

¹² Federal Deposit Insurance Corporation. “FDIC Law, Regulations, Related Acts – Federal Deposit Insurance Act.” <http://www.fdic.gov/regulations/laws/rules/1000-1700.html#1000sec.15c> (Downloaded April 10, 2009)

¹³ “More on the F.D.I.C.’s ‘No-Loss’ Loan Guarantees.” *The New York Times*. April 9, 2009. <http://dealbook.blogs.nytimes.com/2009/04/09/more-on-the-fdics-no-loss-loan-guarantees/> (Downloaded April 10, 2009)

Inadequate Protections Against Waste, Fraud, and Abuse

POGO is also concerned that the FDIC has not clearly articulated a strategy for protecting taxpayers from waste, fraud, and abuse in the LLP.

We appreciate that the terms of the program acknowledge the potential for conflicts of interest among private investors and provide some initial restrictions. For instance, the terms mandate that “cooperation between Private Investor groups will be prohibited once the auction process begins,” and also that “Private Investors may not participate in any PPIF that purchase assets from sellers that are affiliates of such investors or that represent 10% or more of the aggregate private capital in the PPIF.”¹⁴

In the weeks since the LLP was announced, however, concerns have been raised in the media and elsewhere that there are additional ways in which participating firms could potentially “game the system.” Many of these loopholes apply to both the LLP and the Legacy Securities Program. For instance, *Financial Times* recently reported that major TARP recipients such as Citigroup and Goldman Sachs are already considering buying toxic assets from their rivals, bidding up prices using the leverage provided by the federal government.¹⁵ And a recent *Business Week* article imagined a scenario in which private investors could overbid for loans held by banks in which they own significant stockholdings, thereby driving up the banks’ shares.¹⁶ We call on the FDIC to explain in much greater detail what it will do to mitigate these and other potential conflicts.

In the terms of the LLP, the FDIC also announced that it will be hiring third party valuation firms to “provide independent valuation advice to the FDIC on each Eligible Asset Pool.” However, there is no mention of what the FDIC will do to ensure the independence of these firms. In its guidelines on “Minimum Standards of Integrity and Fitness for an FDIC Contractor,” the FDIC writes that a conflict could arise when a contractor “has a personal, business, or financial interest or relationship that relates to the services” performed under the contract.¹⁷ In this case, a third party firm might offer biased valuation advice if it has a financial interest in the bank selling its toxic assets. We urge the FDIC to clarify whether or not the third party valuation firms hired under the LLP will be restricted by the FDIC’s conflict-of-interest rules and regulations. If not, we call on the FDIC to draft specific rules and regulations for the LLP third party firms, in order to ensure that the valuation process is implemented without any bias or favoritism.

¹⁴ Federal Deposit Insurance Corporation. “Legacy Loans Program: Summary of Terms.” <http://www.fdic.gov/llp/LLPtermsheet.pdf> (Downloaded April 10, 2009)

¹⁵ Francesco Guerrera and Krishna Guha. “Bailed-Out Banks Eye Toxic Asset Buys.” *Financial Times*. April 2, 2009. http://www.ft.com/cms/s/0/358e479a-1fbf-11de-a1df-00144feabdc0.html?ncllick_check=1 (Downloaded April 10, 2009)

¹⁶ Theo Francis and Mara Der Hovanesian. “Geithner’s Plan: Loopholes Galore.” *Business Week*. April 1, 2009. http://www.businessweek.com/magazine/content/09_15/b4126020226641.htm (Downloaded April 10, 2009)

¹⁷ Federal Deposit Insurance Corporation. “Part 366 – Minimum Standards of Integrity and Fitness for an FDIC Contractor.” <http://www.fdic.gov/buying/goods/acquisition/Part366.doc> (Downloaded April 10, 2009)

Furthermore, we are skeptical of the FDIC's claim that "each PPIF must agree to waste, fraud and abuse protections to be defined by UST and the FDIC in order to protect taxpayers."¹⁸ The FDIC needs to elaborate in much greater detail what it will do to protect taxpayers, especially since there is such a strong potential for the FDIC to incur significant losses through its obligations, and since there appear to be ample opportunities for private investors to "game the system."

In conclusion, regardless of whether or not the LLP will achieve its stated goal of cleansing distressed loans from the balance sheets of banks, POGO believes that concerns about the program's legality are of such significance that the FDIC should not proceed without explicit sanction from Congress. It is irresponsible to place billions of taxpayer dollars at risk without any Congressional approval or oversight. If the FDIC decides to move forward with the LLP, we strongly urge it to wait for Congress to clarify and expand its authority before taking on such significant liabilities. We also recommend that the FDIC institute stronger measures to protect taxpayers from waste, fraud, and abuse.

Thank you for your consideration of this public comment. If you have any questions or would like to discuss these issues further, please contact me at (202) 347-1122

Sincerely,

Danielle Brian
Executive Director

¹⁸ Federal Deposit Insurance Corporation. "Legacy Loans Program: Summary of Terms." <http://www.fdic.gov/llp/LLPtermsheet.pdf> (Downloaded April 10, 2009)