Sunsen Capital: Response to FDIC Request for Comments on Legacy Loans Program (LLP)

The Legacy Loans Program (LLP) has the potential to help purge the toxic assets from the balance sheets of the nations' FDIC-insured financial institutions, allow the banking system to resume sensible lending, and lead our economy on the road to recovery. The FDIC has asked for comments on all aspects of the proposed LLP. Before we begin addressing the specific questions that the FDIC has outlined, we wanted to offer some guiding principles that we believe should govern the design of the program (as well as all Financial Stability programs). In formulating these guiding principles, we thought about how we ended up in this mess – that is, what themes permeated the wild financial orgy at the tail end of the boom and ensuing bust. Our analysis led us to the following:

4 Principles that Led Us to Economic Ruin

1. **Complexity**
2. **Opaqueness**
3. **No Accountability – "Heads I Win, Tails I Don't Lose"**
4. **No Common Sense – "The Model Said So"**

Realizing how magnificently disastrous the application of these principles has been (and understanding the limits of our own minds to ponder this too deeply), we thought that application of the opposite would be beneficial:

4 Principles that Will Lead Us to Economic Recovery

1. **Simplicity**
2. **Transparency**
3. **Accountability – "Heads I Win, Tails I Lose"**
4. **Common Sense – "Modeling is Imperfect So Have a Margin of Safety"**

It is with these 4 Principles in mind that we offer suggestions that we believe will maximize systemic economic recovery while understanding the practical constraints of bank and investor participants. Please note that despite our desire to be as neutral as possible, we expect to participate on the investor side of the Legacy Loans Program and thus our answers may be colored by this perspective (we hope not too much).

In various sections of this document, we will refer to a concept called Derived Investment Value (DIV). This idea is taken from the days of the Resolution Trust Corporation (RTC) and it was a methodology for valuing portfolios of commercial mortgages to facilitate bulk sales of such assets. We will call the results of the independent valuation consultants DIV though we understand that the concept will likely take some new name in the LLP.

The Legacy Loans Program *could* be a great step in unclogging the flow of credit in our economy. The Resolution Trust Corporation has already demonstrated how to pull off the PPIP concept successfully from a post-receivership start. However, the LLP's efforts (at least now) are in the pre-receivership arena. The major hurdle of the program will be the wide disparity between the banks' book values for these assets and what they will be worth at auction, even with the generous taxpayer financing. Successful implementation and execution of the program will require careful foresight and a clear, transparent design.

We hope that you will find our thoughts useful and insightful. If we can be of any further assistance, please do not hesitate to contact us.

We look forward to participating soon,

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FDIC Questions

1. *Which asset categories should be eligible for sale through the LLP? Should the program initially focus only on legacy real estate assets or should any asset on bank balance sheets be eligible for sale? Are there specific portfolios where there would be more or less interest in selling through the LLP?*

   Any assets on bank balance sheets should be eligible for sale. However, there needs to be some logic to each pool of assets for sale. In order to extract maximum value for the banks, assets should be pooled by type or by geography. The costs of managing and extracting value from a pool will detract from the price paid by investors. Investors tend to have expertise in concentrated areas, the greater the diversity in the types of assets in a given pool, the greater margin for error that will be built into a buyer's return analysis and the greater the need to hire outside expertise for areas in which the buyer does not have its own – both of these obviously come at a cost, a cost that will be subtracted from the amount the investor will be willing to pay.

   Pooling assets more tightly may pose logistical problems for participating small banks because there may not be enough loans from a given small bank to create a narrowly defined pool of sufficient size to make administrative sense to auction. Pooling assets across banks makes more sense, however due to a bank's option to accept the winning bid there are logistical challenges in doing so. We are opposed to this option as it constrains key facets that would facilitate smooth execution of the Legacy Loans Program and has the strong potential to lead to a further loss of investor confidence should auctions start failing due to the banks not accepting the winning bids. We will discuss the problems posed by the option in subsequent questions as well.

2. *Should the initial investors be permitted to pledge, sell or transfer their interests in the PPIF? If so, how should the FDIC ensure that subsequent investors meet the program's criteria for investors?*

   This is a difficult question. Increased liquidity of any asset, an equity interest in a PPIF included, obviously increases its value. However, if we have learned anything from the financial quicksand we find ourselves in, it should be that people make better decisions when they are forced to live with the longer term consequences of those decisions. We fear that if we too loosely limit the transferability of the General Partner PPIF interests, we will be encouraging the same game of financial hot potato that we should be trying to avoid. If the program does allow transfers of GP interests, it should be "at the sole and absolute discretion of the FDIC."[1] Anything short of that and we fear that the program is opening itself up to administrative nightmares at best and money and time-wasting lawsuits and injunctions at worst.[2] Pledging, selling, or transferring PPIF interests should be strongly discouraged except in exigent circumstances. The main argument we can see for allowing such actions is so that investors' needs for short-term liquidity (particularly in the case of a pool being purchased by a single or small number of individual investors) does not create a situation where the investor/manager does not try to maximize long-term value for *all* shareholders inclusive of the passive government shareholders in the PPIF.[3] Transferring non-controlling Limited Partner interests within the GP investor entity should be allowed

[1] Investors would obviously have to meet all program criteria for transfers.
[2] Think about the counterparty circus that has been created in the Credit Default Swap market.
[3] We can envision a scenario where the manager's short-term cash needs cause him to quickly wind down a PPIF instead of trying to maximize its long-term value.

since enforcement against doing so would be difficult and such transfer should not have material impact on the performance of the fund.

Pledging the GP interest can lead to unintended consequences. What if the creditor forecloses on the interest? Though we acknowledge that some version of a customized swap agreement could always be used to simulate a transfer of economic interest – in this case, enforcement by the FDIC would be very difficult.

The official policy should be no pledging, selling, or transferring of interests is allowed except under exigent circumstances and allowance of such shall be "at the sole and absolute discretion of the FDIC."

3. *What is the appropriate percentage of government equity participation which will maximize returns for taxpayers while assuring integrity in the pricing by private investors? How would a higher investment percentage on the part of the government impact private investment in PPIFs? Should the amount of the government's investment depend on the type of portfolio?*

In an initial essay that we wrote earlier this year on the financial bailout, we contemplated this question. In this essay, we did not address the various distinctive characteristics of land loans, construction loans, REOs, and operating property loans, but rather focused on what is a good generic capital structure for a PPIF that would provide enough incentive for investor participation, a fair return to taxpayers, and enough leverage to narrow the bid-ask spread on toxic assets without creating an inordinate amount of moral hazard; we settled on 70 - 80% non-recourse debt financing, 20 - 30% equity financing, and half of the equity financing coming from taxpayers treated equally (*pari passu* as those more cosmopolitan than we are likely to say) with investor equity.

When we revisit this issue, we largely stand by that capital structure (and it does not appear to be too far from the maximum 6-to-1 debt-equity framework that the FDIC has suggested). The amount of FDIC debt should be adjusted depending on the type of assets in the pool[4], however we think that in the interest of keeping things simple, the proportion of government equity to investor equity in each PPIF should be constant and we believe the proposed 1-to-1 ratio[5] seems reasonable. We also think there are a few ways to improve the structure. First, there should be an incentive (promote) structure on the government equity in the PPIF – an issue that we have not seen addressed anywhere. Second, in return for the incentive structure, the taxpayer equity should have 100% priority payback over the investor equity.[6] The taxpayers trade some of the upside for more security. Due to the asymmetry in decision-making ability within the PPIF, we think this makes sense for government LPs; the private sector investor should be in the first loss position. The government should be focused on capital preservation, a fair return, and having its capital returned as quickly as possible. Third, we do not believe that there should be management fees on the government equity. In colloquial finance talk, we believe there should be something similar to the "20" but not the "2" of the "2 and 20" hedge fund structure.[7]

[4] With less leverage for more risky assets such as land and construction loans.
[5] Or a 51/49 LP/GP ratio as was done in many RTC partnerships, also with LP having right to remove GP in certain instances.
[6] That is taxpayer equity is not returned until 100% of government equity has been returned.
[7] We could also envision a preferred return to all cash equity and a slightly higher incentive structure.

4. *Is there any reason that investors' identities should not be made publicly available?*

   No, there is no reason that the General Partner's identity should not be made public. There should be full transparency with respect to investor selection and winning bids. However, we do not believe that all Limited Partners of the GP entity need to be disclosed unless they meet a certain threshold for investment.[8] We also assume due to the fact that virtually all mortgages are publicly recorded (and we assume a majority of the assets in these programs will be residential and commercial mortgage loans), there will be little way to hide the identities of selling banks so their identities too should be revealed in the interest of transparency. It may be prudent not to reveal names of banks that merely participate, but do not actually sell assets.[9] If mortgages were not publicly recorded, we are unsure whether it would be wise to reveal selling banks' identities – thankfully the longstanding laws of the land have spared us from devoting brainpower to this exercise.

   We want to stress the need for a high degree of transparency in this program. Americans already have a great distrust of the way that bailout programs (TARP, AIG, etc..) have been administered. After a PPIP has been wound down, records of the partnerships' performance should be made public as well. We do not, however, believe that it makes sense to publicly release quarterly progress/performance reports during the life of a PPIP. These reports should be collected and monitored by the FDIC as stewards for the public but revealing their contents before a PPIP is wound down would release too much sensitive and competitive information.

5. *How can the FDIC best encourage a broad and diverse range of investment participation? How can the FDIC best structure the valuation and bidding process to motivate sellers to bring assets to the PPIF?*

   A simple and transparent system in which the rules are clearly laid out (and not subject to continual change) will encourage a broad and diverse range of *suitable* investor participation – we stress suitable because there is a difference between what is necessary to encourage the most participants and what is necessary to encourage the most suitable participants. By suitable, we mean willing, able, and accountable investors; those who have the funds and are willing to put their money on the line in a first loss position. Investors should be pre-qualified by depositing 50% of the required investor equity for the pool.[10] Any winning bidder who fails to close should forfeit their deposit. The blow to confidence of failed auctions will be substantial – there needs to be a substantial penalty for doing this.

   One thing we are vehemently opposed to is participation on the investor side by Troubled Assets Relief Program (TARP) recipients and Temporary Liquidity Guarantee Program (TLGP) participants. Recently, we have read that some of the larger TARP recipients are planning to participate in these programs as investors. This is fundamentally wrong for a couple of reasons. First, TARP recipients are already receiving government aid so essentially their participation is 100% financed by taxpayers – even their equity is coming via cheap government funds. Second, many TARP recipients have a substantial amount of toxic assets on their balance sheets. These two facts create significant moral hazard; there is a strong incentive to bid up these assets as it can increase the values of their overall books. Making matters

[8] Something along the lines of 25% of the private investor equity capital for a given pool.
[9] This may or may not be possible depending on the level of detail that is revealed in bid packages.
[10] That is an amount that corresponds to 50% of the equity for their planned maximum bid, though some investors may want to post more so that they have more flexibility to increase their bids.

worse, if and when these assets are eventually shown to be worth less than the inflated prices that were paid, 100% of the burden of overpayment will be borne by taxpayers. Finally, the entire purpose of all of these programs is to increase the system-wide flow of credit. If TARP banks are buying up toxic assets with their funds, that money is not going to making new loans and increasing the flow of credit. If the cost that Barclays had to pay for its capital to be free of government aid restrictions are indicative, TARP and TLGP recipients are getting an incredibly good deal from the government. If these firms wish to benefit from the benevolence of the US taxpayer, they should focus on fulfilling their patriotic duty by making new loans to creditworthy borrowers; investing in the LLP does not go towards that goal.

We are less opposed to banks participating on the investor side in these programs if they are not benefiting from TARP or TLGP and are incurring market rate costs of capital like the rest of us.[11] Though there is still plenty of room to game the system by bidding artificially high prices to justify unrealistically high loan marks – all at the ultimate expense of taxpayers. We believe the best method is to not allow any FDIC-insured institution or their affiliates to participate on the investor side.

We are not sure that there are any reasonable ways to structure the valuation and bidding process that will motivate banks to participate (that are fair to taxpayers). We suspect that successful execution of the Legacy Loans Program will require considerable carrot and stick inducement behind the scenes by regulators[12] to *encourage* bank participation. In many cases, bank regulators will be required to engage in the politically unpopular act of shutting down banks.[13] As Tim Geithner said in recent House of Representatives hearing "this plan will work … it just requires will, not ability." Do the bank regulators[14] have the will to do what needs to be done?

6. *What type of auction process facilitates the broadest investor participation? Should we require investors to bid on the entire equity stake of a PPIF, or should we allow investors to bid on partial stakes in a PPIF? If the latter, would a Dutch auction process or some other structure provide the best mechanism for bridging the potential gap between what investors might bid and recoverable value? If multiple investors are allowed to bid through a Dutch auction, or similar process, how should asset management control be determined?*

This is another area where we believe that simplicity is best. We believe that a straightforward auction that is administered online would facilitate the broadest range of investor participation. Pre-qualification and secure online authentication mechanisms will be important to executing this successfully.

Groups should be able to join together to bid, but it must be done in advance and a single bidding entity must be formed for a given pool. Bidders should not be able to bid on partial stakes in a PPIF. There will be tremendous logistical headaches with regard to asset management and strategic decision-making if partial stakes are allowed (unless they are purely limited partnership interests). We do not believe that a

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[11] Even still, we wonder why banks should be spending resources on managing toxic assets – shouldn't they spend their resources on making and managing good loans?
[12] Temporary relaxation of required capital ratios and longer amortization periods for recognizing losses for participating banks could be two such inducements.
[13] There were 745 bank failures during the Savings & Loan Crisis of the 1980s and 1990s and this situation is at least as bad and we have had relatively few bank failures to date.
[14] OTS, OCC, and FDIC.

Dutch Auction process (similar to how Treasuries are sold) would work well. This format tends to work best for highly commoditized instruments. These toxic asset pools will be rather heterogeneous compared to Treasuries. Control struggles will slow things down and cause too many problems. Too many "cooks in the kitchen" always ruins the meal.

7. *What priorities (i.e., types of assets) should the FDIC consider in deciding which pools to set for the initial PPIF auctions?*

We assume that most assets in the LLP will be real estate-backed loans. Real estate problems usually take these general forms: good real estate suffering from an oversupplied local market, real estate which is badly located or poorly designed and constructed, unfinished real estate,[15] and real estate with title problems.[16] In the interest of gaining momentum for the LLP, the initial auctions should focus on loans backed by good real estate in oversupplied markets as these will likely gain the most investor interest and result in the least discount to book value for the selling banks.

We must note that there is continual threat of further asset and collateral deterioration in loans involving unfinished real estate and real estate with title problems. Despite their low values and extremely low liquidity in markets such as these, these are the loans that most need to be put in the hands of able investors so that their values do not plummet further while in the hands of financial institutions. However, we are keenly aware of the need to get the LLP off to a good start and therefore bringing the most toxic of the toxic assets to auction first seems unwise. In addition, land and construction-related loans (or any loans that have little to no cash flow, but unfunded expenses) pose a new set of requirements and challenges that need careful deliberation.

8. *What are the optimal size and characteristics of a pool for a PPIF?*

The optimal characteristics of a pool should be a focus on geography and/or asset type. This will be a very important characteristic in achieving highest price for the selling banks. Smaller pools will lead to greater competition among buyers (and higher sales prices), however there are administrative and logistical costs that need to be considered. In addition, many small pools will slow down execution of the LLP. A good approach would be to use a range of pool sizes to target different sized investors. We would guess that about $10 million of investor equity would be an appropriate constraint for the minimum pool size. Using a 6-to-1 debt-to-equity ratio and assuming 50% government equity participation, $10 million would equate to a minimum pool purchase price of $140 million. Pools that are too large will also limit competition among investors; we estimate something along the lines of $2 to 3 billion for the largest pools.

9. *What parameters of the note and its rate structure would be essential for a potential private capital investor to know at the time of the equity auction to provide equity?*

We would want to know the proceeds, rate structure, reference rate for a floating rate note, any points (on both entry and exit), debt retirement / paydown requirements, any prepayment penalties / yield-

[15] In process construction or renovation projects.
[16] Can also suffer from more than one of these problems. (Source: B. Ely, "The Resolution Trust Corporation in Historical Perspective" in *Housing Policy Debate*. Vol 1, Issue 1).

maintenance requirements, term, any extension options (and cost of exercising those options), required interest reserves, and any required financial or operating ratios. Causes for default, penalties, and cures would also be helpful, but not essential. We are assuming the note will be non-recourse with standard bad boy act carve-outs and will not have any margining requirements.

10. *Would it be preferable for the selling bank to take a note from the PPIF in exchange for the pool of loans and other assets that it sells? Alternatively, what would be the advantages and disadvantages of structuring the program so that the PPIF issues debt publicly in order to pay cash to the selling bank? Would a public issuance of debt by the PPIF limit its flexibility compared to the issuance of a note to a selling bank?*

    From the investor perspective, it would be preferable for the selling bank to take a note from the PPIF assuming that the overall cost of debt funding was similar to cost of issuing public debt. There would be benefits from the speed of execution of a simple process.

    However, selling banks may not be in favor of this method. Assuming a 6-to-1 debt-to-equity ratio, the selling banks would get only a modest amount of cash at closing. They could sell the note in the secondary market to raise cash, however the liquidity of a market for this FDIC-backed note needs to be studied. We suspect that there would be a reasonably liquid market for this type of government-guaranteed note, but the loan/note market would not be as liquid as the market for publicly issued debt.

    The main advantage of the PPIF issuing debt publicly would be a likely lower rate on the funds (assuming FDIC guarantee). Of course if the FDIC were to arbitrarily mandate a low rate on the note that would be better for investors. The main disadvantaged of public debt would be time to execution – we need to get this moving fast. We would be in favor of slightly higher rates in the interest of getting the program moving quickly.

11. *In return for its guarantee of the debt of the PPIF, the FDIC will be paid an annual fee based on the amount of debt outstanding. Should the guarantee fee be adjusted based on the risk characteristics of the underlying pool or other criteria?*

    The FDIC's guarantee obligations deserve careful analysis as is it is likely that any cost associated with it[17] will eventually be paid for by taxpayers. It would be fantastic (and equitable) if the private sector (investors and banking industry) were to repay the public for the costs associated with this cleanup, but history tells us that this is doubtful.[18] There are two main levers that the FDIC can adjust to limit its net exposure; loan to cost (LTC) of PPIP debt (%) and guarantee fee (%). It is our belief that the guarantee fee should be set at a fixed percentage of the amount of guaranteed debt across all PPIPs. While *in theory*, you should be able to adjust either lever to end at a similar result, having consistency across the fee lever will keep things cleaner and simpler. We have just been through an era where financial firms thought that they could appropriately model and price any type of risk[19] – the fallout from which has been catastrophic. Most models are imperfect and thus it is prudent to have a "margin of safety." We consistently underestimate the costs of resolving impaired debt situations. Therefore the FDIC should focus on adjusting for the risk characteristics of the underlying pool solely based on the amount of

[17] That is guarantee fees taken in minus (-) guarantees paid out (-) administrative costs.
[18] Out of the total estimated $152.9 billion dollar cost for the S&L clean-up (including FSLIC and RTC), $123.8 billion, or approximately 81%, was paid for by the public sector (Source: T. Curry and L. Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences" in *FDIC Banking Review*).
[19] We believe most would agree at this point that many of the highly leveraged, teaser rate, negative amortization, and other exotic loans simply should just not have been made regardless of the pricing.

leverage that it is willing to guarantee for a given pool, its LTC.

12. *Should the program include provisions under which the government would increase its participation in any investment returns that exceed a specified trigger level? If so, what would be the appropriate level and how should that participation be structured?*

    No. We do not believe that investors should be penalized for better performance. A vast majority of joint venture (JV) partnerships we have seen over our careers offered a flat or progressive incentive structure (in fact we are scratching our heads to think of a real world deal where there was, in effect, a penalty for better performance). Our preference is to keep it simple with a flat incentive structure. We are opposed to the regressive performance structure contemplated here. We are not in favor of the more typical progressive incentive structure either (one where higher returns yield a greater percentage of those returns) as the asymmetry of the loss and gain might yield imprudent risk-taking at the margins. In addition, we see no reason for very complicated waterfall structures – let's keep it simple.

13. *Should the program permit multiple selling banks to pool assets for sale? If so, what constraints should be applied to such pooling arrangements? How can the PPIF structure equitably accommodate participation by smaller institutions? Under what process would proceeds be allocated to selling banks if they pool assets?*

    The program should permit multiple selling banks to pool assets for sale under certain conditions. First, the pooling banks should all be small enough that pooling is necessary to facilitate their participation in the LLP. The FDIC would have to somewhat arbitrarily decide on a size threshold – this threshold could be based on actual bank size by assets or on the size of the asset pool that a bank contributes to the LLP.[20] Second, after finding out the results of the third party appraisal of the pool, the banks must commit (or not commit) to selling into the auction. They give up their options to not sell if they do not like the winning bid – this will minimize the chaos that could ensue if after the auction some banks in a pool want to sell and others do not.[21] In return for giving up their options, the FDIC will guarantee a minimum price to the banks based on the Derived Investment Value (DIV) of the submitted assets. The exact way that the FDIC could implement this could take a variety of forms. The guaranteed price could be:
    - X% of DIV in sales price, where X is < 100
    - X% of DIV in sales price + Y% of DIV in preferred equity investment in the bank directly, where X+Y < 100

    The first method would provide cushion so that taxpayers are not overpaying too much if the bids come in low – setting the level at about 70% seems reasonable. The second method would limit overpayment as well while also providing a ready way to shore up bank capital (and earn a return for taxpayers). Under all scenarios, banks must make their decision based on the DIVs that are calculated – each bank's share of the proceeds will be based on their pro rata share of DIV for the pool. We are not sure if this method can realistically be used for larger banks. However, if the quality of the DIVs from the RTC can be duplicated in the LLP, then it is unlikely that either guarantee mechanism will be used in practice. During the RTC, actual collections as a % of DIV, ranged from 93% to 123%[22] - a reasonably tight range. The biggest challenge will be in plugging the capital holes left when the DIVs and actual bids come in significantly lower than the numbers at which banks are carrying the assets on their books.

[20] A large bank with few toxic assets to sell could conceivably fall in this category.

[21] 7 small banks pooling assets and then each deciding independently whether to sell after seeing the winning bid will surely be a chaotic process.

[22] S Series: 123%, N Series: 119%, SN Series: 113%, MIF Series: 101%, NP Series: 122%, Land Funds: 93% (FDIC Division of Resolutions and Receiverships).

14. *What are the potential conflicts which could arise among LLP participants? What structural arrangements and safeguards should the FDIC put into place to address or mitigate those concerns?*

    Self-dealing is the major conflict of interest that the LLP needs to address. Self-dealing can take two forms – a buyer affiliated with a selling bank purchasing loans at an inflated value or an end buyer affiliated with an investor purchasing a disposed asset at a discounted value. Both cases have strong potential to harm taxpayers. Self dealing should be generally prohibited and there should be severe penalties for unauthorized self-dealing. However, there may be occasions, primarily in the latter case, where selling to an affiliated end user may be beneficial for all PPIP stakeholders. There should be pre-defined criteria and process for obtaining a waiver from the FDIC to allow this. We envision something such as the following:

    - A PPIP manager formally petitions FDIC for a waiver and outlines the reason for such waiver
    - Affiliated buying entity makes offer with non-refundable deposit[23]
    - There is a mandatory notice and waiting period to see if others will match or beat offer
    - If nobody matches or beats the offer, then affiliated party can make the transaction

    We want to make a note of something else here because this seems like the most appropriate section to do so. There needs to be more aggressive criminal prosecution of those who commit white collar crimes and abuse the system to reap ill gotten gains. We have a problem that in our society, when a poor man steals some food to feed his family, he seems to be penalized much more than a Wall Street trader who steals $10 million from taxpayers. We mean the kind of trader whose firm receives TARP money and he knowingly inflates the value of his trading book (because he can mark to model) to get a big bonus at year end, the book *somehow* collapses in January, and he just shrugs his shoulders, takes his $10 million bonus, and takes some time off. Let us be clear, we have no problem with large bonuses (the $100 million plus hedge fund kind included), when they are earned fairly. But there needs to be greater fear instilled in the hearts and minds of the financial community because the current weak threat of penalty is not strong enough to deter those with marginal ethical standards.

15. *What should the relative role of the government and private sector be in the selection and oversight of asset managers? How can the FDIC most effectively oversee asset management to protect the government's investment, while providing flexibility for working assets in a way which promotes profitability for both public and private investors?*

    The FDIC should publish clearly defined criteria as to requirements and disqualifications for asset managers. The actual selection should be made by private sector investors though the FDIC should have approval (confirmation) rights over selections. There should be rigorous oversight by the government of the entire asset management process. Private sector GPs should be required to provide quarterly reports to the FDIC and the format and expected content of such reports should be made clear at the outset. The requirement of government approval for the sale of assets above a certain dollar threshold *may* be a good oversight technique but only if the government sets up a specialized department[24] to handle this function and there is a relatively short window for a rejection."[25] All PPIPs should be subject to random audits as well.

[23] Non-refundable if nobody outbids them only.

[24] Either within the government or outside, but it may be better to contract third parties to provide this function – the firms who provide independent data collection and valuation on the pools would be a likely choice as they already have familiarity with the assets.

[25] Particularly when you consider the relatively faster pace with which private sector participants analyze and execute decisions.

16. *How should on-going servicing requirements of underlying assets be sold to a PPIF and paid for? Should value be separately attributed to control of the servicing rights?*

    The on-going servicing requirements should be bundled with the PPIF. The private sector investment manager should then decide how it wants to handle servicing – either handle in-house or sell them to an outside party. The FDIC should ensure that PPIFs that choose to service assets in-house have the infrastructure to do so or should it order the sale of the rights if not. In the case of in-house servicing, there should be a standard formula for calculating allowable fees. The FDIC should distribute a list of approved third party servicers and allow the private sector manager to independently direct and negotiate the sale of the rights. The rights should not be auctioned off separately to minimize potential conflicts between PPIFs and servicers.

17. *Should data used by the independent valuation consultant, as well as results of such consultant's analysis, be made available to potential bidders? Should it be made available to potential sellers prior to their decision to submit assets to bid?*

    Yes. The RTC used a metric called Derived Investment Value (DIV) which alleviated a good bit of due diligence by bidders. We need to get this program successfully moving to facilitate our economic recovery. These independent valuations and their associated data will be extremely useful for potential bidders. While most astute investors will undoubtedly supplement DIVs with proprietary due diligence, DIVs and their assumptions would be a good starting point that will save time and cost.

    As far as the potential sellers are concerned, providing the data and results will be very helpful in helping them mark their books and understand realistic valuations for their assets. We believe that many banks are looking at the values of their non-marked-to-market assets through rather rosey-colored glasses.[26] Providing the independent valuations to banks prior to their decision to submit assets to bid will scare some banks from auctioning assets, though it is probably better that they do not submit assets if they are not realistic about pricing. However, even if a bank ultimately chooses not to sell their assets through the program, the mere existence of such valuations will put banks in a difficult position if their internal marks are significantly higher than those of an independent third party – how does bank management justify that to their regulator?

Additional Questions

- What social pursuits will be mandated under the program? Will there be limits on foreclosures or other resolution tools? Are there any affordable housing requirements? Will there be "anti-dumping" statutes?
- How will the need for further capital be handled (this will particularly be of concern for land and construction loans)? Can capital calls be made? Will the government equity have to make a capital call? If not, how will additional investor contributions be handled?
- How will the warrants be handled? Will there be further dilution of investor capital?

[26] Loans are usually not marked to market and banks have tremendous discretion on when and how to recognize impairment of these assets.