Private-Public Investment Program Legacy Loan Program
Response to FDIC Request for Comments

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?***

   We believe the policy goals of the PPIP program should be to:

   - Increase confidence in and stability of the US banking system by reducing the significant exposure to impaired and deteriorating assets
   - Enable new lending by removing capital-consuming assets from bank balance sheets
   - Direct sufficient work-out expertise to troubled assets to ensure their resolution in a manner that achieves the highest value possible while protecting homeowners, their communities, and the broader economy from the damage resulting from a prolonged downturn

   Therefore, the asset classes that should be targeted are ones that

   - Are large in absolute size and therefore represent a significant risk mitigation and capital re-allocation opportunity for FDIC-insured depositories
   - Are experiencing high levels of delinquency and default
   - Have uncertain values in the eyes of potential investors in the depositories
   - Are operationally challenging, requiring significant expertise and investment of scarce operating capital to manage and resolve

   There are between $1.4 and $2.4 trillion of delinquent and at-risk residential mortgage loans currently in the system. Auctioning these loans would remove them from the banking system, restoring liquidity that could be reinvested into new earning assets. Additionally, if these assets are purchased by qualified investors with dedicated special servicing platforms offering borrower-based loss mitigation strategies, a large number of mortgage loans could be restructured or modified to avoid foreclosure.

   In order to provide the greatest benefit, the LLP should focus on assets that are negatively impacting the balance sheets of FDIC insured institutions today and those that have characteristics indicating elevated risk of near-term default. These assets would include:

   - All delinquent residential mortgage loans and assets (30+, 60+, 90+, in bankruptcy, in foreclosure, REO)
   - Loans with risk characteristics that indicate the loan has a high probability of becoming delinquent in the future; such criteria include:

- Interest-Only, Option ARM and ARM loans
- Stated Income loans
- High LTV loans
- Loans to lower-FICO borrowers
- Loans in economically-distressed regions of the country
- Loans that are current today but have had prior arrearages or other high risk characteristics
- 2nd lien loans

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?***

The increased liquidity from transferability of interests would help bid prices. Investors will likely include both managing investors (MI's) and more passive financial investors (FI's). Initial financial investors should be permitted to transfer their interest in the PPIF as long as the assuming investor meets the original eligibility criteria. Managing investors should also be allowed to transfer their interests but only if the assuming managing investors have the capital, expertise, and asset servicing capabilities required.

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?***

The amount of equity participation by the government should be structured to provide private investors sufficient incentive to participate. The currently proposed 50% participation of government should be sufficient to meet that objective. Higher investment percentages on the part of the government may discourage investors from participating or raise questions of control. Flexibility in the amount of the government's equity participation by portfolio type and risk characteristics may be situationally appropriate, but could also be a complicating factor during the bidding process.

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

The identification of the investors should follow current industry norms wherein the managing investor is identified, but the passive investors are not identified.

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?***

<u>Bank (as Seller) Participation:</u>

The current PPIF proposal provides attractive conditions for banks to realize fair value for their assets. The program provides for a competitive bidding process, transparency, certainty of execution, and government-provided financial leverage. These benefits, especially the availability of government financing, means that prices obtained will likely be the highest, most realistic values the marketplace is willing to place on these assets. Any banks that do not take the opportunity to sell assets in the program may have an unrealistic or uninformed view of asset values.

Given the policy goals of (i) increasing confidence in the banking system, (ii) reducing “albatross” investments to enable new lending, and (iii) directing sufficient attention to troubled assets to ensure their resolution, we believe that banks with exposure to subject assets and their regulators should seriously evaluate a decision not to sell assets through the program.

Procedurally, participating banks should provide adequate information to investors regarding the underlying assets, including customary loan level data, collections history and comments, and other standard servicing information. Market standard loan level representations and warranties should also be provided to protect investors from inappropriate liabilities related to prior legal compliance and documentation deficiencies. Potential bidders should be provided adequate opportunity to review and analyze the information in preparation for the bid.

<u>Investor Participation:</u>

Clear and Consistent Rules: To encourage investor participation, the rules regarding the auction, the ongoing partnership, the conveyance of the loans and the ongoing servicing requirements should be clearly established, widely-disseminated, and held consistent.

Qualification standards: Qualification standards should be established to attract a wide spectrum of qualified investors. However, the investors will also be managing billions of dollars on behalf of the taxpayers of the United States, and will be dealing directly with American families regarding their financial situation. Therefore, the lead, or managing investors, for each bidding group must demonstrate experience and expertise valuing, managing, servicing and reporting on the underlying assets as well as being a proven and accredited servicer of consumer loans.

Specific qualification standards should include:

- Expertise to *properly evaluate and diligence the underlying assets*, including established asset diligence capabilities, experienced loan file review teams and processes, established collateral valuation capabilities and processes, and extensive financial analysis and modeling capabilities
- *Established asset servicing capabilities*, including loan servicing, loss mitigation, customer service, and asset-based resolution capabilties, and the ability to implement loan-level asset resolutions in direct communication with borrowers
- *Servicing capacity* to manage at least $1 billion in assets
- *Licensed to service loans nation-wide*
- *Recognized as an approved servicer* by a nationally recognized rating agency and at least one of the GSE’s

- *Highly trained staff*, trained in consumer laws and compliance as well as functional specialties, managed and incented to enhance the value of the assets
- *Technology capable of offering loss mitigation alternatives* (including the recently announced Home Affordable Modification Program) to borrowers
- *Established network of third-party service-providers and vendors,* as appropriate
- *Reporting capabilities* to properly track, value and report detailed information on each asset under management

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?***

   - Investors should bid on the entire private partner equity stake of a PPIF. Partial bids would unnecessarily complicate the bidding process.

   - Bidders should provide as part of their bid a reasonable plan for how the assets will be managed on behalf of the investors and taxpayers. The loan servicer should ideally be directly owned by the managing investor, or at least be willing to commit its capital to the investment to align its interests with that of the other investors and the government. Many industry problems today stem from a lack of alignment between investors and servicers.

   - The auction process should be designed to follow standard market protocol for selling loans. This most efficient procedure is a two round bidding process where the highest 2-3 bids from the initial round are invited to conduct more detailed due diligence on the assets. At the conclusion of the diligence, the second round bidders submit their final bid. The second round bidders whose bids are not accepted should be reimbursed for their due diligence expenses up to a predetermined cap (approximately $300 per loan) to encourage greater participation.

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

   Priorities should target loans whose disposition could positively impact the economic recovery. The highest priority should be given to non-performing and at-risk residential mortgage loans, with a particular focus on mortgage loans held by institutions with overburdened mortgage servicing operations that are not able to implement effective loss mitigation. Qualified bidders of residential mortgage loans must have a mortgage servicing partner with adequate special servicing capacity and infrastructure to offer a full array of borrower-based loss mitigation solutions. Enhanced special servicing offered by the successor servicer will improve borrower performance through proper loss mitigation, reducing foreclosures and preventing further deterioration in home property values.

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

- Pools should vary in size to attract the broadest bank and investor participation while keeping the process manageable:
  - Assets from small banks should be pooled up to $100-$500 MM pools
  - pools of $500 MM to $2 B are likely to be the most common and attract the most interest
  - Larger pools of up to $5 billion in face value are feasible to help larger banks dispose of their exposures, but large pools will likely attract fewer bids as few bidders will be able and willing to dedicate the substantial resources required to perform due diligence on a large number of small-balance loans. Additionally, the issue of special servicing capacity becomes more of a constraint at large sizes as well
- Pools should be homogenous and contain similar assets. Performing and non-performing loans could be mixed together, but asset types, such as small commercial, land, and REO should be segregated. It is typically best to also segregate loans from different sellers, although some pooling from smaller banks may be necessary as noted above.

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?

As a general principle, debt should be match funded with the underlying assets to avoid liquidity problems. Debt should not be marked-to-market and should be repaid as funds are received on the underlying assets.

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?

We believe that the recently proposed structure where banks can choose to participate by taking back notes from the PPIF is appropriate. PPIF debt instruments should be issued to the lowest cost source, be that public debt or privately placed with the banks. Public issuance of the debt may have more limited flexibility for future changes to the terms, however, as long as the terms of the debt are fully disclosed at the time of bid, investors and sellers will have the opportunity to evaluate this information.

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?

Yes, the FDIC fee should be risk based, reasonable, and properly disclosed at the initial marketing of the pool.

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?***

    A simple set structure of ownership would encourage widespread investor participation. A structure that allows the government to increase its ownership participation if the returns exceed a specified level complicates the investment structure and may remove incentive for the private investor. If the private investor's participation is diluted after returns exceed a specified level, it may undermine the incentive to maximize the value of the portfolio.

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?***

    Pools comprised of loans from multiple sellers should only be used to serve smaller banks who cannot independently offer large enough pools to attract sufficient investor interest. However, it is important that the expectations for multiple seller pools be established prior to the bid. Most importantly, all the individual sellers must be required to sell the loans if the aggregate reserve or target price is met. No seller should be allowed to remove loans from multiple seller pools as this would result in changes to the overall makeup and risk characteristics of the pool. The successful buyer could provide loan level pricing so that each seller could receive the appropriate economics from the sale.

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?***

    Conflicts can be minimized by clearly establishing the business arrangement, roles and responsibilities prior to the bid. By submitting a bid, the private investor would be accepting those terms and conditions. Once the partnership is established the business arrangement should not be permitted to change at the unilateral determination of one of the parties. All parties must agree in writing to any subsequent changes.

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?***

    Private investors should control the asset management and the loan servicing and be responsible for ensuring that assets are serviced according to relevant laws and any additional procedures agreed to at the time of sale. These procedures should include performance reporting standards such that the government will receive detailed reporting on the status and progress of each asset.

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?***

Managing investors should be responsible for the servicing of the underlying loans, with servicing control and servicing rights transferring to the investor. Optimally, the managing investor and the asset servicer will be part of the same organization, avoiding potential conflicts and ensuring that loans get focused attention. In any case, asset servicers should invest equity capital side-by-side with private and public investors to ensure meaningful alignment of interests. The cost of the servicing should be included in the original bid price.

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, if independent valuations are available, this information should be provided to potential bidders and sellers so that they may determine their willingness to participate in the sale. Experienced investors and sellers, however, will likely rely on their own analysis.

<u>Other relevant questions</u>

Should banks be allowed to participate in the program as investors?

Allowing banks to participate, especially ones that have received explicit or implicit government assistance, is not productive. Asset risk is not removed from the banking system, just moved around amongst FDIC-insured participants, lending capacity is not meaningfully increased, and taxpayer capital is used for purposes beyond the original intent of the bank rescue programs.

Will industry standard loan level representations and warranties be provided by the selling institution?

This will maximize the value of the loans and protect the purchaser from liabilities related to the origination, ownership, conveyance and prior servicing of the mortgage loan.

Will assets with compliance issues be removed from the loan sales?

Investors should not be expected to assume liabilities from illegally or improperly originated or serviced loans. For example, all High Cost, Section 32 or other loans that violate federal, state or local lending laws should be removed from sale. Appropriate put-back or hold-back mechanisms are needed to effectuate this.