PENTALPHA

April 9, 2008

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

Dear Mr. Feldman,

Thank you for the opportunity to present Pentalpha's brief comments with respect to the Legacy Loan Program. We hope that you find them helpful as you work to design the program.

Pentalpha Global Advisors is a leading capital markets advisory firm that has worked extensively with the FDIC in the valuation and liquidation of failed bank assets. We devised the structured transaction offered for the NetBank collateral and are currently beginning work on an aggregated portfolio of Acquisition, Development and Construction (ADC) loans.

We would welcome the opportunity to meet with you in person to further discuss some of our thoughts and ideas with respect to the Legacy Asset Program and are available at your convenience.

Very truly yours,

Timothy W. Dwyer, Managing Director
Pentalpha Global Advisors

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Legacy Loans Program
Program Description and Request for Comments

The Treasury and the FDIC recently announced that they will establish the Legacy Loans Program (LLP) to remove troubled loans and other assets from banks. This program is necessary because uncertainty about the value of these assets makes it difficult for banks to raise capital and secure stable funding to support lending to households and businesses. All FDIC-insured depository institutions will be eligible to participate in the program.

While the idea of having the government purchase loans and other assets from banks has been proposed before, the problem of determining a fair price for the assets has prevented the idea from moving forward. The concern has been that a price set by the government might result in overpaying for the assets.

To address this concern, the Treasury will join with private investors to purchase these assets. This combination uses the expertise of the private sector and discipline from the financial markets to determine a market-based price for loans and other assets that have been hard to value.

The vehicle for purchasing assets from a bank will be Public-Private Investment Funds (PPIFs). Private investors will bid for the opportunity to contribute up to 50 percent of the equity for the PPIF. The winning bid for this equity share will set the implied value of the equity share held by the Treasury. With proposed financing guaranteed by the FDIC, this will define the overall price offered to the selling bank.

Because the government will be in partnership with private investors, the government will share in any profits. If private parties profit from their investment, as they expect to, the Treasury will also. At the same time, the Treasury will only suffer losses if the private investors do.

Credit markets have not functioned well recently because of a lack of financing for certain assets. To address this, a PPIF will be able to issue FDIC-guaranteed debt. For providing the guarantee, the FDIC will be paid a fee, a portion of which will be allocated to the Deposit Insurance Fund. The FDIC will be protected against losses by the equity in the pool, the newly established value of the pool's assets, and the fees collected.

This program will be coordinated with the other components of the financial recovery package to clean up bank balance sheets so that banks can once again provide the lending to further the recovery of the U.S. economy.

II. Request for Comment

The FDIC is requesting comment from interested parties on all aspects of the proposed LLP. In particular it has formulated the following questions for interested parties to consider:

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?

    1. Size and quality of the collateral data is the determinate. Small deals with weak data will result in many problems. If the collateral data items can be aggregated into institutional amounts, there should be no collateral type limitations. Lead with residential first. It currently has the most liquidity.

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?

    1. No. If you want a partner, they should remain as your partner throughout the duration of the program. There are very few success stories about the transfer. There are too many potential transfer conflicts, operational issues etc.

    2. If the current partner wants to dilute a minority interest and maintain the GP functionality, that could possibly work. This concept would require significant transfer restrictions, it if is to be considered seriously. We have voiced them to the FDIC previously.

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?

    1. The ownership amount is not the driver. The income amount to the partner is the driver. Size only provides bragging rights. If the government wants to speculate by being a long term owner (as opposed to a seller at today's levels), they should keep as much of the risk as possible and take a strong hand in operational oversight. Someone in the FDIC needs to make the difficult decision of hold vs. sell then structure a custom deal based on the available optionality.

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

    1. What is the upside in not disclosing it? In general, this should not be confrontational. You are trying to move massive amounts of money in this program. If you lose a handful of investors because they are fearful of a disclosure issue, they will not be missed. The secretive buyers tend not to be the highest bidders.

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?

    1. The seller needs to identify what sale price works. Then the FDIC team can identify a way for it to reach that goal (combination of guarantee and leverage). Until a few deals are processed, it is difficult to create a process where bidders spend significant funds trying to guess if they can reach the seller's undisclosed targets.

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?

    1. You are looking for a partner to CREATE value. Let them assemble their own LONG TERM capital structure to allow them to offer this operational lift. Marrying people with possibly different abilities and motivations doesn't sound like a compelling concept to begin with.

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

    1. Lead with the easier assets (non-performing residential). There are lots of buyers and they are willing to work hard to structure deals. They are also highly motivated because no other supply exists.

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

    1. The pool size irrelevant. It is the investment amount that matters.

    2. $100 million of equity invested is a good target amount to start. Not too big, not too small. That is a lot of loans if the guarantee and leverage is maximized.

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?

    1. This question is confusing. Sorry.

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?

    1. A private partnership selling public debt is a good idea. If that debt is also guaranteed (fractionally or 100%), it will trade at low yields which will allow the partner to pay the FDIC a higher price upfront. The combination of guarantees and leverage can generate some very high prices.

    2. Step one is guaranteeing the most. Second step is levering that guaranteed asset through public auctions. If it is guaranteed, the investors will have little interest in the credit “story” except for duration management issues.

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?

    1. The FDIC is becoming a “super monoline”. This requires risk based pricing, transaction engineering and best in class surveillance to get the money back.

    2. Pricing the risk upfront is very difficult because of the collateral that is involved. It is more important to have best in class recovery operations.

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?

    1. We have calculated this for the FDIC as part of our Net Bank project in the past. We encourage you to call us for some insights into the complexities we considered.

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?

    1. Aggregation is easy if there are reps. If there are no reps, the challenges grow exponentially. A rep is effectively a guarantee. If you are willing to guarantee assets now, providing reps should not be as offensive as originally thought. Please call us for our thinking related to our current assignment for the FDIC.

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?

    1. We have significant first hand knowledge on this. Here is a partial list.

        1. Tax

        2. Duration

        3. Operational abilities and sophistication

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?

    1. Assume that the manager will become adverse to the FDIC in the future. Sad to say, but true. Look how many AAA investors are complaining that the B piece investors are not doing the “right thing” for the pool as a whole. There are simply too many different alignment of interest issues, especially in the tail period of the collateral pool’s life. You should consider creating a resolution specialist position for the term of the deal.

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?

    1. Definitely separate the servicing function. You may need to transfer it if the manager underperforms or the servicer underperforms. No transfer rights without FDIC approval however.

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?

    1. No. Each bidder should develop their own opinion.

    2. The data that the third party valuation vendor uses, should be made available however.

Comments on the LLP may be submitted until April 10, 2009.

You may submit comments by any of the following methods:

- E-mail: LLPComments@FDIC.gov. Include "Legacy Loans Program" in the subject line of the message.
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivery/Courier: Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m. (EDT).