Comments on the FDIC Legacy Loans Program

Thank you for the opportunity to offer comments and suggestions on the FDIC's recently announced Legacy Loans Program (LLP) for Public-Private Investment Funds (PPIFs). I have reviewed the materials made available on the FDIC website, including the transcripts of the two web conferences held with Bankers and the Media. Having considered all of the information currently made public, I have the following thoughts. Thank you for your attention.

PARTICIPATING BANKS

1. Asset Eligibility Criteria. The eligibility criteria should include quantity factors as well as quality factors. In order for the auction diligence and bid processes to work effectively and expeditiously, the number of assets placed into any single Asset Pool should be limited. This would allow the FDIC to create specific timetables for completion of each step in the pre-auction process. For example, if the Asset Pool were of a manageable size, due diligence should be completed within a short period (7 days?).

2. "Too Big to Fail". In order to avoid creating new financial institutions whose demise would impair the entire market, there should be limitations on the number of Asset Pools that may be acquired by a PPIF and its affiliates. This limitation would also serve to disperse the investments among a larger group and promote more geographic diversity of PPIFs. The limitation could be expressed either in terms of the raw number of Asset Pools acquired or, perhaps more appropriately, in terms of the dollar volume of the assets being acquired.

3. Consultation with Participating Bank's Regulator. The Legacy Loans Program Summary of Terms allows (requires?) Banks and their regulators to contact the FDIC. Does this mean that the FDIC will require a consent or affirmation by the regulator? Obviously such a requirement would slow down the process, and therefore create another bureaucratic impediment. Each Participating Bank should merely be required to provide its regulator with a written statement of its proposed application (and the contents) at least 7 days before the Participating Bank submits the application to the FDIC. The failure of the regulator to object within the 7-day period would be considered to be its consent or affirmation.

4. Voluntary or Mandated Participation. The LLP appears to permit banks complete discretion in the decision whether or not to participate. It would be preferable if each bank's regulator exercised more authority, where appropriate, to encourage participation by banks with large holdings of troubled loans. Has the FDIC had any discussions with the regulators about expectations for the direct involvement of the regulators in the participation decisions of the banks?

5. Asset Pools. The process may break down if Participating Banks have a power to reject the highest auction bid. This will discourage participation by PPIFs who will have expended time and money to develop a bid, only to have the Participating Bank render all of that time and expense (as well as a waste of the time and resources of the FDIC) futile. Participating Banks should be permitted to identify a minimum amount, below which any bid is unacceptable. That minimum acceptable amount should be included in the package of information that is published to advertise the auction of that Asset Pool. Once the auction is concluded and the FDIC awards the winning bid, the Participating Bank should not be permitted to nullify the entire process by exercising a power to reject that winning bid.

6. Incentives. In exchange for the requirement that the Participating Bank commit to a minimum acceptable price up front, the LLP should provide for a forfeiture of the 5% deposit to the Participating Bank in the event the winning PPIF fails to close.

7. Collective Asset Pools. Reportedly the FDIC is contemplating whether the process may later be expanded to permit multiple Participating Banks to combine assets into a single Asset Pool. If this were to occur, it is even more compelling that a Participating Bank not have a right to decline the winning bid. By contrast, each contributing Bank could identify the minimum acceptable price for the assets which it contributes to the Asset Pool. A reserve is clearly preferable to a rejection power.

8. The Assets Themselves. Presumably the initial goal of the Legacy Loans Program is to allow Participating Banks to sell their troubled loans. However, each of those loans represents a borrower, a promissory note, security of some sort and a filed security interest. It is not clear from the PPIP announcements to date whether the FDIC contemplates that the due diligence process will attempt to identify risk and debt service ability by reason of group estimates or by direct review of each loan that may be included in an Asset Pool. Obviously individual inquiries would take time and delay the process, but estimates formed from a large group may prove to be quite misleading, particularly when the borrowers who are included within that group may have changed economic circumstances since initially taking their loan. Keeping the Asset Pools relatively manageable and using individual borrower information to assess risk and debt service coverage would appear to provide more certainty for PPIFs.

FDIC REVIEW

9. Acceptance. The FDIC should develop and publish the list of specific factors that it will apply in determining whether or not to accept an offered Asset Pool. A realistic evaluation of the Participating Bank's minimum acceptable price should be one of those factors.

10. FDIC Due Diligence. Due diligence should focus on two topics: (i) an evaluation of the underlying security for the loan(s) and (ii) an evaluation of the ability of the borrower(s) to perform. The first topic would appear to be so related to the real estate market that it raises the question of whether or not the Third Party Valuation Firm

should be in the real estate business. The second topic would appear to be so dependent upon the borrower's finances that it raises the question of whether or not the Third Party Valuation Firm should be in the debt counseling business. Is it anticipated that the Third Party Valuation Firm engaged by the FDIC will be geographically connected to the Participating Bank or to the situs of the majority of the assets in the Asset Pool? Who pays for the services of the Third Party Valuation Firms?

11. Information Availability. It would certainly be helpful if the FDIC could establish a safe internet site where the results of the FDIC-initiated due diligence could be posted. However, since much of that information may be confidential with respect to each asset in the Asset Pool, could that information be selectively redacted before entry into the public domain so that individual privacy is protected? If such a site were to be created, how would the cost of maintenance of the site be handled by the FDIC?

12. Leverage. Lack of a consistent and uniform practice for determinations of the leverage amount could conceivably become the source of great dispute. Since the leverage amount will vary from deal-to-deal, will the seller or the buyer have any rights to appeal the FDIC's leverage determination with respect to any particular Asset Pool? This should be discouraged since it would only delay the process. Ideally, the leverage amount will be based on the Asset Pool and not on the size of the proposed equity to be invested by the PPIF. The timing of the determination of the leverage amount needs more clarification. The leverage amount should be published by the FDIC at the time it announces the Asset Pool and the auction. Will there be any circumstances under which the FDIC could change the leverage after its initial determination?

13. Timing. This is a very important subject because of the sensitivity of the underlying assets in the Asset Pool and the vulnerability of some of the borrowers whose mortgage notes are included in the Asset Pool. An expeditious process should be emphasized at each step. If possible, the FDIC should publish a preferred schedule of steps for each proposed Asset Pool, due diligence, auction and closing. While there may be necessary occasional departures from the schedule, the FDIC should require the parties to adhere to the schedule. All of the participants, including the outside parties (such as the Third Party Valuation Firms), should be strongly encouraged to meet their deadlines. Moreover, if any of the parties consistently delays, the pre-qualification or participation right of that party should be revoked prospectively.

PPIFs

14. Pre-Qualification. Since a PPIF will not know the amount of equity it must raise privately until it knows the size and estimated value of the Asset Pool being offered, the qualifications for the PPIFs will have to be measured in terms other than capital. If, as suggested in the Legacy Loans Program Summary of Terms, the FDIC intends to encourage participation by small, veteran-, minority- and women-owned firms, will the FDIC's pre-qualification application be written to solicit information on those subjects? What factors will cause the FDIC to refuse to consider the pre-qualification application of a PPIF? What factors will cause the FDIC to decline to pre-

qualify an entity applying to become a PPIF? Will there be a fee for applying to become pre-qualified? Will there be a fee for pre-qualification?

15. Effect. The FDIC should make it clear that pre-qualification means that if the pre-qualified PPIF submits a winning bid, the 50% Treasury match and the FDIC guaranty are automatic. Will the list of pre-qualified PPIFs be made public? What will cause a previously-pre-qualified PPIF to become disqualified?

16. Funding. The FDIC's expectations for PPIF funding are unclear. A PPIF won't know the extent of its full need for private equity until it knows that its bid has been accepted. Presumably Treasury will not contribute its equity share to a PPIF until the PPIF needs the funds to close an Asset Pool purchase. The FDIC should permit PPIFs to accept initial private equity contributions to provide the funds needed for organizational expenses and to enable the PPIF to make the 5% deposit required of it.

17. Treasury Participation. Treasury is to participate as a 50% contributor to the equity of the PPIF. The LLP Summary of Terms says that the Treasury will receive warrants consistent with the terms of the Emergency Economic Stabilization Act and the TARP Capital Purchase Program (CPP). However, those CPP warrants address a unique situation which will not be repeated in the LLP. Those CPP warrants were issued by publicly-held corporations. By contrast, the PPIFs will most likely be privately-held (except for the Treasury portion). Moreover, PPIFs do not necessarily have to be corporations, and some may choose to be limited liability companies or some other entity that avoids double taxation. Third, those CPP warrants were priced by reference to the underlying stock's 20-day trailing average. These PPIFs will not have 20-day trailing averages. Fourth, because each TARP recipient has a quoted market price, it is easy to determine at any given point in time whether the warrant is in or out of the money. There are unlikely to be any market quotes for the equity in PPIFs. Fifth, the CPP contained significant provisions for a Reduction in those warrants, whereas the Treasury share of the PPIF's equity is intended to be a long-term investment. Sixth, capital was already injected into the CPP participants in the form of Preferred Stock. By contrast, each PPIF will need the Treasury's equity immediately in order to close the purchase from the Participating Bank. All of these differences suggest that it would be more appropriate for the Treasury to receive a direct ownership interest, rather than warrants.

18. PPIF Due Diligence. There should be a brief, tightly-controlled opportunity for a pre-qualified PPIF to do its own Asset Pool due diligence when it is not satisfied with the amount of information available through the FDIC's due diligence process. The information developed by the PPIF's due diligence should be provided to the FDIC so that it can (i) determine whether that new information should be added to the information already provided publicly, (ii) decide whether the general nature of the inquiry is worthy of being added to the list of standard due diligence undertaken by the FDIC for future Asset Pools and (iii) assure that the due diligence undertaken by the PPIF was not done purely for purposes of delay.

19. The Bid. The basis for the award to the highest bidder is unclear. The nature of the process suggests that almost all of the bids will be in exactly the same amount – a combination of the private and Treasury equity plus the FDIC-guaranteed debt. How will the FDIC decide among bids of equal amounts?

20. Overbids. Are there circumstances under which a PPIF would be permitted to bid more than that amount by obtaining more private equity (thus unbalancing the 50-50 relationship with Treasury) or by issuing more debt (that is not subject to, and junior to, the FDIC guaranteed debt)? If a PPIF is permitted to raise more private equity in order to make a higher bid, does the Treasury still have a 50% equity stake?

21. Risk. The timing of the process may cause a PPIF additional risk. For example, one or more of the investors providing the private equity could drop out at some point between the PPIF's initial bid and the closing of the sale of the Asset Pool. What recourse does the Participating Bank have if the PPIF is unable to close? What recourse would the PPIF have if the Participating Bank fails to close? Who bears the risk that the assets that comprise the Asset Pool decline significantly in value between the submission of the original Asset Pool and the closing?

22. Equity. Presumably the private equity issued by each PPIF will be subject to Federal and State securities law requirements. Is it contemplated that the Treasury's portion of the equity will be excluded from those requirements, and if so, will this require amendments to Federal and State securities laws? Will the Treasury's equity share be exempted from specific tax laws (as are Treasury's earlier CPP investments)?

23. Debt. Will the FDIC dictate the terms of the PPIF's guaranteed debt? If the FDIC guaranty is to be secured by the assets in the Asset Pool, what will be the relative priorities of that security and the underlying security in the form of the mortgage or trust deed that is recorded at the location of each component of the Asset Pool? Does the FDIC anticipate filing any kind of a security instrument to record its senior position with respect to the guaranteed debt? Will the FDIC generally permit junior debt or will that decision be made on a case-by-case basis (and with terms of the junior debt being subject to approval by the FDIC)?

24. The Deposit. If the winning PPIF fails to close the sale, it forfeits the 5% deposit. As suggested earlier, this deposit should be forfeited to the Participating Bank.

AUCTION/SALE

25. Confidentiality. This may be the biggest challenge for the FDIC - how to put enough information in the hands of potential bidders without exposing confidential information belonging to either the Participating Bank or the individual debtors?

26. Site. If the confidentiality issue can be successfully resolved, then the FDIC could set up a secure website where the relevant information could be viewed by potential bidders. The FDIC could assign to each pre-qualified PPIF a user number and

a password that permits entry to the secure website. Each password would allow entry only to a specific auction site. If possible, there should be some controls to prevent an authorized visitor to the website from making or allowing that confidential information to become public.

27. Logistics. Bids should be communicated to the FDIC via the internet. Those bids should not be public. When the FDIC awards the winning bid, it should be communicated to the PPIF both via the internet and by regular mail. The winning PPIF should acknowledge its selection by written communication to the FDIC and that communication should propose a closing date which should be not more than 60 days after receipt of notice that it is the winning bidder. Once the winning PPIF has acknowledged its selection, the FDIC should identify it to the public via the internet. Because the Treasury is an equity stake-holder in the winning PPIF and because the FDIC is guarantying its debt, the amount of the winning bid should also be made public. Unless there is an allegation of fraud by the winning PPIF or misconduct by the FDIC, there should be no appeal from the award of the winning bidder.

28. Inadequate Bids. In the event the Participating Bank sets a minimum acceptable price, which is not satisfied by any of the PPIF bids, the Participating Bank should not be permitted to re-offer any of the assets in the proposed Asset Pool for a "cooling off" period – preferably one year or more. This would avoid wasting further time and resources of the FDIC and help to ensure that the Participating Bank packages a marketable group of assets in the Asset Pool and sets a realistic minimum acceptable price for that package.

29. Terms of Sale. If possible, the FDIC should develop a standard form of contract for the sale of the Asset Pool to the winning bidder. The Participating Bank should have an opportunity to request revisions to the standard form at the time it offers the Asset Pool, but those revisions should be subject to FDIC acceptance or rejection. The FDIC should review those proposed Participating Bank revisions from the standpoint of a potential buyer, rejecting anything that is commercially unreasonable or anything that would put the buyer at a disadvantage (such as a disclaimer of knowledge of information about the collectability of particular assets in the Asset Pool). The FDIC should be permitted to engage outside counsel for this process, with the fee of outside counsel being capped and being charged back to the Participating Bank. Any revisions to the standard form should be clearly identified with the FDIC's offer of the Asset Pool for auction, so that any potential bidder has the opportunity to see beforehand what additional terms are to be imposed on it. If possible, the FDIC should minimize the delays inherent in negotiations over the terms of sale documents between buyer and seller.

30. The Guaranteed Debt. Comment has been requested on the issue of whether the PPIF's guaranteed debt should be included as part of the exchange with the Participating Bank or should be sold directly to the public. It is preferable to have the PPIF market the debt and not the Participating Bank. First, the expenses incurred in the debt offering and sale are properly attributed to the PPIF, and the Participating Bank

should not have to underwrite those expenses. Second, most PPIFs will be better situated to make a debt offering. Third, it would be unwise to distract the Participating Bank with the burden of having to re-sell the debt at a time when it should be concentrating on rebuilding its capital. Fourth, the PPIF is in a better position to begin marketing the debt immediately after it has been notified of its winning bid, compared to the Participating Bank which presumably would have to wait until the transaction closes. Fifth, the cash infusion to the Participating Bank should be accomplished at the earliest possible date (the closing), and should not be contingent on the success of the Participating Bank in re-marketing the PPIF's debt.

31. DSCA. Apparently the Debt Service Coverage Account (DSCA) is to be initially funded by means of a "hold-back" from the purchase price proceeds. This DSCA should be escrowed, without interest. The FDIC should be the escrow agent. Since (i) the FDIC is the escrow agent and (ii) no interest is to be paid on the escrowed funds, the PPIF should be required to compensate the Participating Bank with a premium that approximates the interest that could have been earned by the Participating Bank on the escrowed money before it is paid out to the Participating Bank. That premium could be calculated at the interest rate then being paid by the Participating Bank on 1-year certificates of deposit as of the date of the PPIF "take out" of that portion of the DSCA escrow. The PPIF should be required to replace the Bank-funded DSCA at a rate that approximates the excess of the total monthly collections by the PPIF over a combination of its debt service on its FDIC-guaranteed debt and a fair rate of return on equity (such as the Long-Term Tax-Exempt Rate used for IRC Section 382 purposes and published monthly in the Internal Revenue Bulletin).

32. Servicing Transition. Apparently the LLP is to be structured to permit some flexibility in the transition of the servicing of the Asset Pool from the Participating Bank (or its agent) to the PPIF (or its agent). The rules adopted by the FDIC should also address any tax, insurance and utility escrows that are being maintained by the Participating Bank (or its agent). During any transition period, the PPIF should be required to pay a reasonable servicing fee to the Participating Bank (or its agent). A reasonable servicing fee can be determined by reference to the current market for servicing agents engaged by comparable lenders.

FDIC OVERSIGHT AND FEES

33. Guarantee Fee. The FDIC's Guarantee Fee should be set at a rate that reflects the entirety of the risk of all of the PPIF debt that is guaranteed by the FDIC. Like the regular FDIC insurance on bank accounts, the risk should be spread over all PPIFs that participate in the LLP, regardless of the separate risk factors reflected in any one of the Asset Pools.

34. Administration Fee. Because the FDIC will be expected to perform substantial oversight under the LLP, the Administration Fee should be set high enough to reimburse the FDIC for the added costs of creating and administering a new oversight group.

35. Oversight. Given the recent public outrage over lack of regulatory oversight by other government agencies, the FDIC should establish and operate a strict oversight program. This should include review of each and every Modification of a mortgage loan that is part of the Asset Pool, periodic monitoring of the overall performance of the assets in the Asset Pool, confirmation of all principal and interest payments on the guaranteed debt and investigation of any and all complaints by mortgagors (of the loans that are included in the Asset Pool), investors and creditors of the PPIF and other governmental entities (including local governments that may cite some of the properties upon which the PPIF holds a mortgage). The FDIC should also give some consideration to the creation of a special "Court" to decide disputes between the Participating Bank and the PPIF over claims of breached warranties and representations and the viability of any assets included in the purchased Asset Pool that later are alleged to have been misrepresented.

Very truly yours,

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