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To: LLPComments
Subject: Legacy Loan Program comments

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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?

No comment.

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?

Yes, PPIF interests should be transferrable. Given that the program is addressing the unavailability of market rate debt financing for acquisition of these types of assets, PPIF financing should be divisible and assumable. This is particularly true if PPIF assets are sold in bulk packages, where the individuals loans within the packages are not all desirable or suitable for the initial purchaser. For example, loans might need to be subdivided geographically or by asset type or by size, but they might be sold grouped by institutional source or maturity or size. One obvious likelihood is that some LLP packages will be acquired by larger buyers that do not have the overhead structure to manage the smaller loans and assets in the package, and have to parcel these out to smaller, local firms, who will have even more trouble obtaining private market-rate financing than the larger firms would. As with any other assumable financing, the subdivided PPIF financing would require application by the assumptor to FDIC or its administrator, as the lender, to establish the basic qualifications of the new borrower. Alternatively, FDIC could require a self-certification process by the primary borrower (the initial purchaser) as to the qualifications of the sub-borrower, and any fraud or mis-qualification would become a liability to the primary borrower (perhaps even a recourse liability) – this would save FDIC a great deal of administrative effort and make the program more flexible and liquid.

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 unusual element of the government equity participation in this program is that it is truly pari pasu to the private manager's cash. This is virtually never done in the real estate private equity industry today. Generally, the manager puts up a minority of the equity cash required for an investment with the outside investor (government in this case) putting in a larger part of the equity cash, but the outside investor is earning most of the first returns, with the manager earning a much larger share of the profit if, and only if, the investment exceeds certain return thresholds for the outside investor. For example, In a real estate investment with 80% debt and 20% equity, the outside investor would typically put up 80% to 95% of the equity, with the manager funding the balance. The distribution of returns would be: 1) manager receives a management fee based on asset value, which could be from 1% to 5% depending on complexity and size of asset; 2) actual cash invested earns a "preferred return" (essentially an accruing interest rate) of anywhere from 6% to 15% depending on the risk level of the asset (this heavily favors the outside investor providing most of the cash); 3) returns above the preferred return threshold are divided between outside investor and manager in a series of splits, sometimes called a "waterfall." The split might be 80% of profits to the investor and 20% to the manager until investor has obtained an aggregate internal rate of return of 12%, or 15% or 20%, depending on the risk level of the asset; then a split of 70/30 until the investor has made the next threshold, perhaps 25% IRR on a high risk asset, etc, often with a “home run” bracket for the manager of 50% or even 75% to the manager after the investor has made a very high level of return, perhaps 30% or 40% IRR, depending, as always on the type and risk of asset. This structure encourage the manager to strive for the highest returns, while allocating most of the returns to the investor if the asset does not achieve its targets.

It should be noted that the management fee itself usually is only sufficient to cover actual manager overhead at best, it is not a profit item except for the very largest managers, where the fee becomes totally disproportionate to the labor required to manage assets (the amount of effort required to manage an asset is not at all proportionate to the size of the asset – small assets require almost as much work as assets that are orders of magnitude larger, thus the fee percentage on small assets should be higher.) In other words, managers are looking to the “waterfall,” or “carried interest,” or “promote,” for their profits and incentives.

In the current proposed FDIC structure, where Treasury and Manager are 50/50 and pari pasu, this risks discouraging managers from striving for the highest returns, or perhaps even from participating. Managers would be investing a much higher than typical portion of the equity. They would be earning a larger than typical share of the early, lower returns, but they would earn a much smaller share of the later, higher returns. This suggests they would not be as motivated to seek higher active returns, and would be satisfied with lower, passive returns, which might not be in the government’s interest. Managers expect to make a disproportionate share of profits when they “hit a home run,” and they manage many less lucrative assets and projects for barely more than their fees in order to earn large profits on the occasional major success (much like the venture capital model, where one in ten investments is a “ten-bagger”, and most of the others lose money or break-even.)

Perhaps that is not the model that FDIC is seeking, but it is the one that has evolved in the private markets between investors and managers, especially for the most complex and risky assets, such as unfinished construction projects, environmentally contaminated sites, assets with multiple creditors in bankruptcy, development of raw, unentitled land, failed condo regimes, etc. For very simple assets such as singe-tenant leases with a credit tenant, the return structure is more flat, but for highly risky deals – exactly the ones that the FDIC is trying to remove from banks and unload on private asset managers, returns are never pari pasu all the way up the capital stack, managers have an incentive to undertake the most difficult deals. Again, except for the largest funds, the management fee just “keeps the lights on.” It is the potential for a outsize share of the occasional home run that motivates the best asset managers, especially on small assets of the kind held by most troubled local, community and regional institutions.

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

No comment.

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?

With respect to broad and diverse investment participation on the buy-side, we suggest allocating a portion of PPIP funds for smaller asset and manager sizes. Given the enormous range of values of legacy assets, just a few of the largest failed loans from the largest international lenders would consume the entire program, with nothing left for the numerous small loans that trouble the small, local and community banks that make the great majority of loans around the country, especially to small businesses. Perhaps a certain percentage of PPIP funds should be reserved for legacy loans below $1 million, then some portion for legacy loans below $10 million, etc.

With respect to motivating sellers, this is perhaps the central problem of the program. There is no shortage of motivated buyers for distressed loans in today's market. The problem is that banks refuse to acknowledge the actual value of these assets. Much raw land, for example, simple has no economic value today. The same is true for some partially constructed buildings (the balance of cost to complete may exceed the market value of the property when completed – this is not unusual). Also, many bankers simply do not understand the current value of their impaired assets. They are relying on appraisals that may be several years aold, which in turn were based on comparable sales that are several years older, or were never comparable in the first place (appraisals were very generous in the rising market). Most banks and bankers do not have the capacity to independently assess the investment value of an asset, and with transaction volume falling to near zero in many markets over the past two years, appraisals (which are based on recent comparable transactions) are meaningless. It seems to us that FDIC must force banks to put their assets into the program, and accept whatever auction-based price emerges. In exchange, FDIC grants some regulatory capital relief to the participating banks. But many banks will truly be insolvent with market values on their loans.

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?

Unless the PPIFs are very small, requiring investors to bid on entire packages will exclude most investors, especially if the packages include many different asset types, sizes and locations lumped together. On the other hand, dividing the packages up too finely will leave FDIC stuck with the worst of the worst assets, that no one can be induced to purchase at any price. Some of these assets truly have negative economic value, such as certain unfinished projects where construction cost to complete exceeds final market value, or those with serious environmental liabilities or pending litigation or liens, etc.

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

Presumably those with the greatest risk of additional loss of value if they are not quickly assigned to active managers. But there should probably be a few test case auction with easier assets first, just to smooth out the process.

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

Whole loans should be grouped first geographically, as the underlying assets must be physically managed, and valuations are highly dependent on local market situations. They should then be grouped by size (dollar value), as asset manager overhead structures tend to limit the minimum size of their investments. They should then be grouped by asset type and status, such as whether each is residential, office, retail, hotel, land, mixed-use, etc, and whether completed and leased, vacant, partially constructed, approved but not constructed, or complicated by environmental, entitlement, litigation, tax lien or other hurdles. Within a geographic area and dollar range, different asset managers specialize in each of these asset sub-classes and types of complexity. If the PPIF funding mechanism is easily assumable and subdividable, then these divisions becomes less critical, because a regional acquirer can purchase a larger package of loans and sell small parcels to specialists.

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?

Question: How will PPIP provide funds for completing real estate assets that are not complete and therefore not marketable? If buyers must use additional equity to finish a project, will Treasury match their cash contribution 50/50 upon application? How will such construction draws be administered? This question may be academic, since most loan purchaser will not use equity to fund any substantial construction. They will need debt. So will FDIC provide additional debt for construction (or other special situations, such as environmental clean-up cost, litigation resolution, state tax liens, costs associated with covenant entitlements, etc.)? Probably not. That would be a nightmare for FDIC, which would then be directly running the world's largest construction loan business. The only obviously option is to make the FDIC and Treasury funding explicitly and absolutely subordinate to new secured funds (primarily debt) that an asset manager obtains to complete an incomplete project or fund other special situations.

As for other debt terms, key terms would include assumability, sufficient duration to match the relevant underlying asset class and non-recourse.

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?

No comment.

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, but the asset manager's / purchaser's share of future profits should also be based on these same characteristics, with both higher fee to FDIC and high share of profits to the purchaser for riskier assets.

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?

    This would be the reverse of the typical arrangement in the market, and would disincentivize managers. The manager share of returns should increase if returns exceed certain levels to incentivize higher overall returns. See above.

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?

    Yes, banks should be able to pool by geography, asset type and status, and asset size.

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?

    Here is a big concern: representations and warranties by the seller. Real estate sales, even as-is sales, usually contain disclosure requirements and certain covenant from buyer to seller, especially with regard to marketability of title, environmental condition, tenancies, etc. What recourse will a loan buyer have against a selling institutions if there are misrepresentations or simply a lack of any representations, especially when in many cases the seller is or is certain to soon be insolvent? If the answer is that there will be no reps and warranties from sellers of any kind, and if FDIC will not assume these liabilities, FDIC should expect some very, very low prices for all but the cleanest, most stable (and therefore least likely to be sold) assets. The lack of recourse to seller reps and warranties greatly exacerbates the adverse selection and information asymmetry problems of this program, that banks will be inclined to put their very worst assets into the program, and that only they know (and in many cases, even THEY do not know) the true problems with the asset.

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?

There should be some qualification process based on showing a track record of performance with each underlying asset type and situation within their geographic region, to avoid dilettantes complicating the program administration and creating a second generation of problem assets belonging to PPIP. Minimum size of manager, however, should not be a criterion, because many of the troubled assets are very small, and can only be managed by very small companies. Generally, full discretionary control must be with the asset manager. Most of these companies are staffed very lightly, and they do not have department for reporting to government administrators. To perform financial institution-like oversight of the asset managers would require far, far higher fees payable to the managers, in order to increase their staffing for the sole purpose of managing FDIC or Treasury oversight provisions.

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?

No comment.

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?

The potential sellers should not have a discretionary decision as to which assets to submit for bid – that would perpetuate the current problem in the market. Assuming certain assets must be submitted for bid, making any independent valuation information available to prospective buyers would be positive, since information about these assets is already going to be very limited. The more information is available, the higher the prices will be.