THE LEGACY LOANS PROGRAM:
A CONSTRUCTIVE COMMENTARY

Prepared for

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ABOUT THE AUTHORS

Walter G. Johnson, Jonathan M. Roberts and William C. Vogel, III are the principals of The Third Coast Companies, a commercial real estate investment organization with offices in Cleveland, Ohio and Detroit, Michigan. The company, through its subsidiaries, is involved in the acquisition, investment advisory, structured capital placement/advisory and brokerage of multi-tenant residential real estate assets. Although the authors have experience in nearly every type of commercial real estate class in addition to general multifamily, Third Coast focuses its efforts on other niche tax-advantaged financed properties such as low income housing, Section 8 housing, university student housing, campus apartments and other senior housing (independent living, assisted living and skilled nursing facilities).

Individual author biographies are available in their entirety on Third Coast's web site at www.thirdcoastcompanies.com

ACRONYM KEY

DIF .... Depositors Insurance Fund

FDIC .... Federal Deposit Insurance Corporation

IRD .... Interest Rate Derivative

LIBOR .... London Inter-Bank Offer Rate

LLP .... Legacy Loans Program

LOC .... Letter Of Credit

PPIF .... Public Private Investment Fund

PPIP.. Public Private Investment Program

TARN® .... Taxable Adjustable Rate Note

VRDN.. Variable Rate Demand Note

UST.. United States Treasury

INTRODUCTION

We extend our gratitude and appreciation to the FDIC for providing the opportunity to offer feedback on this important piece of the Administration's economic recovery plan. Although the LLP concept is rooted in firm concepts, it is apparent from both the FDIC's conference call transcript and the questions posed for public comment that many aspects of the program require refinement and additional forethought in order to achieve its stated goals.

We submit this commentary with an eye toward cultivating a program that operates in a transparent fashion, promotes diverse and populous participation and minimizes unintended consequences.

Our comments provide an abstract (summary) answer to each of the question groups posed by the FDIC. Following those comments, we embark on a narrative which discusses the subject which, from our perspective is the most difficult and important piece of the LLP structure: the FDIC guaranteed debt financing. Miscalculation in the structure or support of PPIF debt financing may result in i) sparse participation by the private sector in the LLP, or ii) potential loss of taxpayer capital by the FDIC.

We have developed significantly detailed and expansive thoughts supporting each of the abstracts contained herein. We are willing to share and discuss these with any interested agency, department or group that wishes to engage in meaningful dialogue to benefit the advancement of, or participation in the LLP.

RECOMMENDATIONS

Question Group 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?*

Abstract: Behind a backdrop of proven success and active participation, all asset categories could become eligible for sale through the LLP. However, the initial effort of implementing the LLP should be highly focused on uncomplicated assets/collateral, specifically commercial real estate-collateralized assets, and expanded incrementally upon achieving a streamlined systemic process in conjunction with the desired economic outcome.

Question Group 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?*

Abstract: The initial private investor in a PPIF should not be allowed – or should be significantly limited in their ability – to transfer, sell, pledge or hypothecate their interest in a PPIF. Although this will present a downside in that many potential participants may be turned off by the illiquid nature of their equity position (and consequently risk limiting the universe of potential bidders/investors), this policy will estop a root cause of the economic tumult that exists today by making pool managers and underwriters culpable to their underwriting and valuation techniques. Individual assets from within a pool may be sold, provided the proceeds from such sale are first used to pay any outstanding PPIF debt.

Question Group 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?*

Abstract: 50 percent equity participation is both a reasonable and appropriate level of equity participation in order to i) maximize return to the taxpayer, ii) eliminate complexity and iii) maintain a proper alignment of interests between the public and private PPIF stakeholders.

Regardless of the final concluded equity participation ratio, the private sector investor should always be afforded management control over the PPIF.

__Question Group 4__: *Is there any reason that investors' identities should not be made publicly available?*

__Abstract__: There is no compelling reason to withhold the identities of those entities who participate in the LLP. That said, individual investors in entities participating in a PPIF should be afforded anonymity.

__Question Group 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?*

__Abstract__: The FDIC can create an environment which promotes robust investment participation by ensuring that the asset valuation process is performed with the full participation of the selling banks and providing bidders with full access to the analysis performed.

Additionally, the program must require that selling banks to accept a winning bid if it represents at least, say, 65 percent of the FDIC's established valuation. Allowing the banks to reject a winning bid at any price will repel a majority of potential private sector bidders, whereas establishing a reserve price will encourage participation by the banks.

__Question Group 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?*

__Abstract__: A sealed bid auction process is necessary because of the complexity of the underlying transaction. Further, the winning bidder/investor should be required to purchase the entire PPIF interest. The assets being offered for purchase are likely to require an intense amount of management and oversight, and as such the government should avoid becoming involved in the investor matchmaking process.

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

***Abstract*:** Initial auction pools should be limited to assets which are collateralized by cash-flowing, non-owner occupied collateral, such as multifamily, office, retail & industrial properties. Any assets that involve the valuation of underlying owner-operated businesses, franchises, or specialty single-purpose real estate, such as hotel, restaurant, golf & senior housing properties should be excluded from auction until such time as a successful systemic valuation and auction process has been implemented and proven.

***Question Group 8*:** *What are the optimal size and characteristics of a pool for a PPIF?*

***Abstract*:** Whenever possible, a pool should represent a homogeneous class of assets. Banks may feel that there may be advantages to certain pool offering sizes, and those business decisions should not be interfered with by the FDIC.

***Question Group 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?*

***Abstract*:** Investors will need full disclosure of the terms and rate structure of the assets placed in auction. Additionally, investors will need to know the payment history, terms of personal guaranties, liquidity and credit standing of guarantors. The FDIC should facilitate full disclosure of the entire loan file, including the selling bank's credit risk rating for the assets and the terms of any current or previous forbearance agreements. Ultimately, investors will need enough information to determine an accurate cash flow of a PPIF, after expenses.

***Question Group 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?*

Abstract: In general, cash to banks provides the desired liquidity outcome. If, however, banks have the ability to hypothecate the FDIC-guaranteed notes on a dollar-for-dollar basis, the note strategy is tantamount to providing the banks with cash. The risk, then, becomes one where the banks and FDIC potentially rely entirely on the discount window at Federal Reserve as the ultimate source of funding.

If the FDIC-guaranteed notes are offered any type of advance ratio less than dollar-for-dollar, a bank's willingness to accept a FDIC-guaranteed note as payment for a pool will become significantly diminished.

As an alternative, the public issuance of debt taken on a massive scale could be highly cost effective and provide significant flexibility to the PPIFs (see *Author's Note* below).

Some banks, on the other hand, may find it preferable that they have the ability to participate in the potential upside value by way of taking back a participating FDIC-guaranteed note for certain asset pools. In these participating circumstances, the banks should be compelled to sell the pool at the auction price without reserve.

Author's Note: The public issuance of debt concept is discussed in greater detail in our additional commentary entitled PPIF DEBT STRUCTURE COMMENTARY.

Question Group 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?*

Abstract: Since the FDIC has indicated that it will adjust its risk exposure to a given asset pool based on the amount of leverage offered, it should take a simple approach to establishing a guaranty fee. It can make assumptions regarding potential losses over a period of time and set a 'base fee' that would provide for loss recovery – similar to the calculation used in determining DIF premiums it charges to its member banks. The base fee would be assessed against the total auction price paid by the PPIF. The approved leverage ratio would serve to risk-adjust the effective cost of the FDIC guaranty. For example, a one percent base fee would equate to an effective 1.18 percent fee at 85 percent leverage, or 1.33 percent at 75 percent leverage. Higher risk pools would be offered lower leverage, and thus higher fees as a percentage of debt guaranty. This fixed-guaranty-fee approach will also assist potential bidders/investors in their cost of funds modeling when assessing an auction pool.

Question Group 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?*

Abstract: This concept will not be embraced by the private sector – rather, it will be viewed as a punitive result to achieving the desired outcome. As the taxpayer stands to receive a pari passu distribution of any profits, the FDIC should structure an ongoing and strongly incentivized alignment of interests between the PPIF investment partners.

Question Group 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?*

Abstract: At the onset of the LLP, pools should be segregated by bank to avoid conflicts pertaining to the equitable distribution of auction proceeds. This will create pools of various sizes, and attract like-kind bidders/investors – large investors will bid on large pools, while smaller private investors will bid on smaller pools.

If it is found that minimum pool size is a determining factor to the success of an asset pool at auction, perhaps aggregating several small assets by several small banks may be beneficial. With the passage of time, the expectation of realization on the asset sales could be better determined from prior experience. The method of allocating proceeds between banks could be determined in a more methodical fashion. Alternatively, a privately-negotiated aggregation methodology could be undertaken.

Question Group 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?*

Abstract: Potential conflicts include all of the usual fraud and abuse relating to auctions, including insider information, shill bidding and straw buying to name a few. Careful screening of eligible bidders and tight controls over the conduct of the auction process will aid in mitigating these risks. As we are not experts in auction processes and best practices, we feel that we are unable to fathom all of the possibilities and will leave this to others to better respond.

Question Group 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?*

Abstract: The LLP should adopt a program akin to the '2530' process employed by HUD for allowing participation in several of their affordable housing programs. The private sector partner should be free to choose any servicer, asset manager or similar agent which is not objectionable, for cause, by the FDIC or the UST.

Question Group 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?*

Abstract: The servicing rights should be conveyed to the PPIF as part of the auction price.

Question Group 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?*

Abstract: Yes, absolutely to both questions.

PPIF DEBT STRUCTURE COMMENTARY

A critical factor to the success of the LLP is the FDIC guaranty of PPIF debt used to fund the purchase of pooled assets. A review of the literature available thus far about the LLP is void of commentary specific to the debt side of the PPIF capital structure. Absent a strong commitment to a formal debt structure, we assert that the VRDN is generally the most appropriate form of debt for PPIFs to issue.

Background Issues: Variable Rate Loans & Interest Rate Hedges

Most bank loans are structured as variable rate facilities with rate adjustment tied to indices such as Prime Rate or LIBOR. PPIFs will have to take these variable rate loans into consideration as they fashion their FDIC-guaranteed debt offerings.

Most banks attempt to match fund these assets, often through IRDs such as cap, swap and collar contracts. Banks may hedge their interest rate exposure directly, or require a borrower to enter into an IRD to indirectly provide protection to both the borrower and the bank. The PPIFs will most likely attempt to match fund in a similar manner.

Impact on the LLP PPIF

A selling bank will have to take these hedge positions into account as they place asset pools to auction. Generally, a PPIF will not want to assume or support the existing IRD with the selling bank as a counterparty due to the inability to maintain the perfection of a security interest in the underlying collateral, as well as other economic considerations. Therefore, each asset will have to be evaluated by the selling banks to determine the cost and legal implications relating to the unwinding of these IRDs. The likely outcome would involve the selling bank and the borrower mutually agreeing to terminate the existing IRD under the consideration that each waives their right to any payments due or payable, and agreeing to incorporate the full economics of the IRD into the borrower’s loan. The resulting modified asset would then be the subject offered for sale at auction.

Following the acquisition of an asset pool, a PPIF may, at its discretion, choose to renegotiate any asset in the pool as a means to stabilize the asset. The current interest rate environment, in conjunction with the FDIC-guaranteed debt, could afford that flexibility to the PPIF. Once completed, a PPIF would then likely source IRDs to match its debt to the interest rate composition of the pool. Subject to the capitalization of the PPIF, which may include reserve funds, the FDIC will most likely be required to serve as a guarantor of termination payments on credit-related IRDs. These credit termination guarantees would require an additional fee to the FDIC from the PPIF – similar to the methods employed by Fannie Mae (called a "Hedge Security Agreement") and Freddie Mac in their variable rate low-to-moderate income housing programs.

Loan Prepayments and Defaults

Portfolio bank loans typically do not have prepayment penalties or yield maintenance provisions which often serve to restrict prepayments. In any event, banks must take prepayments into consideration in their capital structure and cost of funds analysis. Flexibility to deal with these prepayments will also have to be a consideration in the PPIF debt structure.

VRDN Structure

With the previous considerations in mind, the most logical debt structure for PPIFs involves the issuance of a variable rate security along the lines of a VRDN. This strategy would afford PPIFs the most flexibility in managing their outstanding debt and related hedges at the lowest possible ongoing cost of funds.

Advantages

Principal Payments. VRDNs are interest-only obligations with optional principal redemption, subject to the requirements and discretion of the note guarantor (in this case the FDIC). Unlike any fixed-rate debt structure, VRDNs allow for principal reductions at any time without penalty to accommodate any prepayments or sales from within a PPIF's pool. Also, if an asset within a PPIF's pool is in default or arrears in its payments, VRDNs afford a PPIF significantly more flexibility with regard to its debt service payable.

Interest Rate. VRDNs have historically benchmarked a LIBOR index. This indexing provides the PPIF with the flexibility to structure IRDs to more closely match the payments on the VRDN with receipts from its pool.

Term Structure. VRDNs are typically issued for extended terms – 20 years and longer – with the ability to prepay at any time. The issuance of VRDNs are contingent only upon maintaining a sufficient principal and liquidity guaranty. This flexible term structure will accommodate the various maturities within a PPIF's pool.

FDIC Guaranty

As previously mentioned, in order for a PPIF to issue VRDNs, the FDIC will need to provide both a principal and liquidity guaranty. This guaranty could be fashioned similar to the methods employed by Fannie Mae and Freddie Mac in their variable rate low-to-moderate income housing programs.

Option. The FDIC could contract with certain high-credit banks to provide a liquidity LOC which would provide the day-to-day processing of draws for the typical liquidity events under a VRDN format. In this scenario, the FDIC would extend its PPIF loan guaranty to cover any failed reimbursements by the PPIF for any liquidity draws.

Market Acceptance. The contemplated FDIC-guaranteed liquidity feature would remove the risk of tenders by note holders recently associated with concerns over the liquidity of banks. We believe there would be broad ongoing market acceptance and very favorable rates on these facilities.

Related Considerations

Collateral. Within the VRDN debt structure, the note holders do not take a security interest in the underlying collateral – their only security is the principal and liquidity guaranty. Therefore, under the VRDN debt structure, the FDIC, as guarantor, would receive an assignment of the PPIF's pool of assets as contemplated. This type of collateral assignment to the FDIC may be difficult to achieve with other forms of secured PPIF financing.

IRDs. The PPIF, by themselves, would likely not be deemed acceptable as a credit risk counterparty to IRD providers. It is likely that a FDIC guaranty would be required to support the credit risk under the IRD contracts entered into by PPIFs. The VRDN note holders would never become involved in the approval of the IRD or the IRD provider. As a way of mitigating IRD counterparty risk to the FDIC, the agency could arrange a short list of eligible IRD providers, similar to those lists utilized by Fannie Mae and Freddie Mac under their established programs of a similar nature.

Capitalized Reserves. Due to the need for the PPIF to i) immediately match the interest exposure on its FDIC-guaranteed debt to its asset pool, and ii) deal with loan delinquencies and defaults, there will likely be instances where immediate capital needs develop beyond the liquid resources available to the PPIF. The FDIC must contemplate and mandate the establishment of some amount of capital reserves by each PPIF at pool acquisition in order to anticipate these situations.

Similarly, PPIFs may have the opportunity to establish debt service reserves during periods when the underlying VRDN interest rate is lower than than that of the pool. The FDIC should consider mandating appropriate levels of cash flow holdback for reserves during these arbitrage periods to further insulate the taxpayer's risk exposure in the PPIFs from interest rate cycles.

Construction Loans. If the FDIC decides to facilitate auctions of bank construction loans, VRDNs can be flexibly structured as a revolving credit facility to easily accommodate the multi-tranche note issuances associated with construction draws.

Conclusion

The authors have decades of aggregate experience in the structuring and placement of VRDNs. They are the creators of the flexible and sophisticated TARN® Financing & Investment Program, a VRDN-style credit facility suited primarily for commercial real estate developers and investors, and are similarly well versed in the credit intricacies of IRDs. They would be pleased to provide a more comprehensive analysis and presentation of the many merits of this proposed debt structure upon request.

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