Recommendation to FDIC Legacy Loan Program

Submitted by Picerne Capital, LLC, Chicago, Illinois

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Picerne Capital appreciates the opportunity to provide comments on the proposed Legacy Loan Program (LLP).

Recommendation:

The paramount issue in implementing the LLP or any similar program is to ensure that banks actually participate and make steady, meaningful progress in disposing of legacy loans, thereby freeing up capital for new lending activity. Accordingly and as further described below, we recommend that a requirement of the Program should be that participating banks must liquidate a specified percentage of their legacy loans, as defined, each quarter, for example 1 or 2%. Absent such a mandate, competitive bids, despite being enhanced with LLP financing and Treasury co-investment, may not be accepted by banks, and the goal of increased liquidity in the capital markets will not be achieved.

Considerations:

Total Commercial Real Estate ("CRE") debt is $3.4 Trillion, with the primary components being Bank Balance Sheet loans ($1.5 Trillion), CMBS ($0.76 Trillion), Life Company loans ($0.3 Trillion) and Savings Institutions ($0.2 Trillion).

We Need Banks to Lend: The current illiquidity in the CRE capital markets is due in large part to the dramatic drop in financing provided by the bond market through CMBS. Recovery in the CMBS bond market will be slow and uncertain, and in the meantime, the only major capital providers capable of filling this void are banks.

Banks Need to Purge Legacy Loans and Assets: In 2005-2007, the CMBS bond market generally offered the most aggressive and competitive CRE financing. Unfortunately for lenders, this resulted in loans with high leverage ratios and at low spreads. Banks competed for and won business in this environment, and unfortunately, are now saddled with legacy assets that are over-leveraged and under-priced in today's market. Banks need to generate loan repayments or sell assets in order to profitably resume active lending on better terms. Absent money "coming back", banks' new lending activity will be greatly hindered.

Banks Won't Purge Legacy Loans Without a Mandate Because They Can't:

Current market bids for legacy loans are too low for most banks to accept as the resulting losses would "wipe out" their equity. For example, loans originated in 2005-2007 were commonly done at 75-80% Loan-to-value (LTV), and in many cases, with little to no principal amortization. From the peak values prevailing at that time, it is estimated that commercial real estate values will ultimately decline 40% with much of this process already underway

(See Deutsche Bank CRE Outlook 1Q 2009; and JP Morgan CRE update 4/2/09). As this projected value decline occurs, 75% LTV loans are, or soon will be, 120% LTV. With the recession causing drops in property-level Net Operating Income, it is inevitable that loan defaults will spike significantly, and with the value erosion, there will be "nowhere to hide". Impaired loans will need to be "marked down", but this process can be as expedient (or as slow) as the auditors and bank regulators demand. Absent a mandate to sell loans, banks will need to rebuild their balance sheets through earnings and very slowly take losses, leading to a protracted period of weakness in the credit markets, similar to that experienced in Japan from 1990 to 2000. The recent changes to the "mark-to-market" rules may further encourage a delay in recognizing losses.

Analysis:

Why Losses Are So Steep and Market Bids So Low: Recovery rates on defaulted CMBS loans are typically 50-60% of the original loan amount. Admittedly, the recovery was a bit higher during the bubble years of 2004-2007, but a regression to more typical ratios (or lower) is expected. For example:

a. Presume a property's value was $100 at the 2006 peak with a loan of $75 (75% LTV); and the property value has now dropped to $60. The question is what will a buyer pay for the troubled loan? If the eventual recovery is expected to be $50 (half the original value), then a bid for the defaulted loan might be approximately $29. By purchasing for $29 with all-equity, and liquidating in 3 years at $50, an all-equity buyer will earn a 20% internal rate of return (IRR). That IRR is a common benchmark for equity returns today. The challenge is that even where the Bank has written down the loan by, say, 20% to $60, the loss on the sale is significant. How will the LLP help?

b. Assume that the LLP will offer its most aggressive terms - 85% debt and half the required equity - and that the buyer still desires a 20% IRR on its investment. (In reality a buyer's return expectation will be higher now that high-leverage has been used). The recovery is still $50, but the bid can be increased to $42. With the $42 bid, the FDIC is providing leverage of $36, and the Treasury is investing $3 as half the equity. The buyer invests $3, and after repayment of debt and interest, splits the $8 of profits with Treasury.

Problem A: As seen above, even with an aggressive LLP, the bank still must take a significant write-down on the sale of an impaired loan. Absent a mandate to sell, many banks will not utilize the LLP as they will choose to hold assets in search of some other solution to their problems or wait for the market to recover.

Problem B: With the recession and declining property incomes, defaults will spike, significantly increasing the number of impaired loans. At present, most loans held by

banks are not impaired and thus are "held for investment" and not "marked-to-market". As a result most banks carry such loans at or near "par" value. As long as these loans do not default, banks will hold these loans at par and hope market values recover before loan maturity (which may be further extended). However, the prognosis for these loans being repaid at par in the near future is poor. Unemployment is increasing and is expected to reach maximum levels sometime in 2010 and commercial real estate loan defaults commonly peak 9+ months <u>after</u> unemployment peaks. Our economy in 2008 was in better shape than 2009, and the FDIC sold: $304 million of "non-performing loans" for 33 cents on the dollar; $229 million of "sub-performing loans" for 46 cents on the dollar; and $702 million of "performing loans" for 79 cents on the dollar (Source: Commercial Real Estate.com). 2009 results may be worse.

Banks' Typical Solution – Delay: Banks commonly write down assets as slowly as possible, and allow earnings over several (if not many years) to pay for the losses. Banks will hold the assets until declining book values inevitably intersect with recovering market values. This may take many years. (In the 1990-1994 downturn, values took 6+ years to recover). In the meantime, banks will be hamstrung in their new loan initiatives as their balance sheets are "clogged" with legacy loans.

A Better Solution: A better solution is for banks to sell assets on an orderly schedule. With minor sales each quarter (say 1-2%), banks will not be forced into precipitous losses and total losses can be managed over time. Moreover, with each sale, the market will become more liquid and transparent, forming a basis for a recovery in values. As an example, GE Capital, a non-depositary institution with a very large commercial real estate platform, has a balance sheet "clogged" with legacy assets. They have publicly stated that they are not making new real estate loans until "they get their book down". According to Cushman & Wakefield, "Lenders who are overexposed to the property market, have effectively withdrawn from writing new business." (Cited in Wall Street Journal, 4/8/09). If we allow banks to remain "overexposed", we will remain in a capital markets gridlock for years.

We believe that experienced buyers of real estate loans concur with our view. To quote just one example, from D. Andrew Beal, Chairman and CEO of Beal Bank, as recently reported by Forbes:

> *He thinks the government is going to be "disappointed" by its various programs to revive lending. He says Treasury Secretary Timothy Geithner's new plan to guarantee loans to buyers of toxic assets won't lead to many sales because the problem isn't liquidity but price. They are not low enough. Half the country's banks--4,000 in all--would be bust, he says, if they marked their loans to what the loans would fetch in an auction. He says banks are fooling themselves by refusing to mark busted assets down.*
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> *"Banks are on a prayer mission that somehow prices will come back and they won't have to face reality," Beal says.*

http://www.forbes.com/2009/04/03/banking-andy-beal-business-wall-street-beal.html

Picerne Capital appreciates the opportunity to provide these comments to the FDIC and would be pleased to respond to any comments or questions the Corporation and its staff may have.

Thank you.

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About Picerne Capital: Picerne Capital is a commercial real estate investment company based in Chicago, IL and is part of The Picerne Group, a privately held U.S. corporation, based in Southern California. The Picerne Group focuses on domestic and international real estate investments, as well as best-in-class asset management. The principals of Picerne Capital have been responsible for over $15 Billion in CRE balance sheet lending in a bank-regulated environment over the past 20 years. www.picernegroup.com