To: Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation FDIC

From: Sandy Vergano
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Re: Comments to Legacy Loan Program

<u>General Comment</u>: If the overriding goal of the PPIP program is to create a market for toxic assets in order to cleanse the balance sheets of participating banks to encourage new lending, I believe the most important thing the FDIC can do is to establish as clear, transparent and determined a process as possible. This should not only encourage maximum participation by various investors but should also allow for more effective oversight, which is important to safeguard the public's financial stake. Many of the comments below will reflect this goal of maximizing certainty and transparency.

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?

<u>Comment</u>: Initially, only legacy real estate-based assets (real estate itself and whole mortgage loans) should be included. The market for real estate assets is more defined than markets for other types of more exotic assets, and therefore should encourage wider investor participation. Limiting the initial phase to real estate will also allow the program to be implemented in a controlled and focused environment. There has been some discussion of including more removed loans (such as mezzanine loans), which I think are too specialized for the initial implementation of the program. It is important to note, however, that this initial focus would not preclude a subsequent expansion of the program into other asset types.

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?

<u>Comment</u>: The initial investors should be permitted to sell or transfer their interests in the PPIF only with the consent of the FDIC, which should apply a similar analysis at the time of the proposed transfer as it applies at the time of initial investment. It would seem

appropriate to introduce a "control" threshold into this discussion; controlling investors would be subject to more stringent transfer restrictions than non-controlling investors; nevertheless, even non-controlling investors should enter into the investment with the expectation that transfer will be possible but subject to certain limitations.

As for pledge rights, the initial investors should not be permitted to pledge their interests in the PPIF. It is important to keep investors' skin in the game. Also, allowing investors to leverage their investments (which the market will value at different amounts at different times) could result in other transfer issues (pledgee enforcement scenarios) which could be disruptive to the wider investment objectives.

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?

<u>Comment</u>: The government's equity participation should be no less than 25% and no more than 50%. Because maximum program certainty is critical, it is important for the government to determine its level of equity participation for each pool of assets and to communicate that fixed determination in advance of bidding by investors.

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

<u>Comment</u>: Balancing transparency with safety concerns, I think the controlling (entity) investor's identity should be made publicly available but not the identities of any non-controlling investors or the identities of the constituent owners of the controlling investor. However, the identity of all direct and indirect investors must be disclosed on a confidential basis to the FDIC and other oversight bodies to ensure adequate oversight.

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?

<u>Comment</u>: The FDIC can encourage a broad and diverse range of investment participation by (a) making the rules of the investment opportunity as straightforward and clear as possible and (b) structuring investment opportunities in various sizes, including smaller, more geographically-focused and/or asset-type-focused pools to permit regional investors to utilize their expertise to maximize investment returns for both the public and private partners.

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?

<u>Comment</u>: *The auction mechanism should be designed to encourage broad participation among qualified investors. This can best be done by having a diversity of pool sizes and compositions. Creating smaller pools will be more time-intensive on the front-end but would be more clear than allowing bidding on partial stakes (for example, how would control of the overall PPIF be handled where multiple partial stakes have been auctioned to different parties?). Investors can always create strategic partnerships outside of the program itself. As for the bidding process, a sealed bid (best and final) would seem like an efficient and reasonable process.*

A discussion about the auction process also implicates a discussion about the bid selection process; namely, does the highest bid always win? Because the public partner's money is as much at risk as the private partner's, it is important for the public partner to be able to take into consideration factors other than price in selecting its private investment partners. Were price the only determinant, the public entity could end up in partnership with a private partner with insufficient expertise, thereby putting the public's money at greater risk for no additional potential return. This scenario would be unacceptable. Instead, the public partner should make clear from the outset that factors other than price will be considered in selecting the winning bidder; those factors should be articulated in advance and made part of the bidding process to enable private investors to provide information about their capabilities for consideration as part of the selection process.

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

<u>Comment</u>: *If one of the main goals of the program is to cleanse banks' balance sheets to encourage new origination, the program should focus on neutralizing those assets that are most obstructive to new origination. Such assets may or may not be the assets that would elicit the most interest among investors, but the ultimate goals should be kept in mind when prioritizing assets.*

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

<u>Comment</u>: *Assuming that selling banks participate vigorously in this process, there should be many assets to deal with. As stated above, it seems that pools should be structured in a variety of sizes to encourage broader investor participation. That said, and assuming investors with large capacity participate in the program, where natural asset clusters exist (similar asset types and/or geographic concentrations), it would seem more efficient to retain rational asset groupings (even if pool sizes become bulky) rather than artificially dividing natural asset groups solely to reduce overall pool sizes.*

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?

No comment.

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?

Comment: A take-back note would be more widely understood by investors and would likely result in more efficient and rapid deal execution. The FDIC guarantee should provide sufficient credit support to make the take-back note relatively liquid.

It goes without saying that the terms of the financing could well determine the overall success of the program. The financing terms should be decided soon and communicated clearly to both the banks that will provide the financing and the investors who will (through the PPIFs) be obligated for it. There has been some discussion about cash flow notes versus fixed-pay notes. It would seem that fixed-pay notes would be more marketable by the bank providing the take-back financing. If cash flow shortfalls occur, both the public and private partners should be required to proportionally contribute additional capital to cover debt service (effectively the public has already assumed the full obligation through the FDIC guarantee), which advances would have distribution priority in the return waterfall under the PPIF agreements. A failure by a party to contribute capital should trigger certain consequences under the PPIF agreements, such as interest accruals to the over-contributing party, loss of management rights for the non-contributing party, etc.

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?

Comment: The guarantee fee should reflect the risk characteristics of the underlying assets (land loans should be treated differently than performing first mortgages) and should be communicated to investors as part of the bidding package. If the fee will be assessed annually, it would seem reasonable to assess the fee against the outstanding principal balance of the underlying collateral at the time of assessment; this would incentivize the PPIF to dispose of assets as quickly as possible, which would in turn reduce the overall public exposure to the program.

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?

Comment: A tiered participation would introduce too much uncertainty into the process and could skew the alignment of interests between the public and private investment participants. Returns should be allocated according to the initial relative equity *percentages. Also, presumably certain PPIF expenses relating to the management of the investment will be reimbursed to the party incurring the expenses for the benefit of the PPIF (which should be the private partner except for extraordinary expenses); the agreements establishing the PPIFs must clearly delineate what types of expenses are permitted (with and without the consent of the public partner), establish how and when such expenses will be reimbursed, and provide clear and regular reporting requirements to allow effective oversight by the public partner.*

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?

No comment.

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?

Comment: Some of the issues that will arise among LLP participants include:

Management issues: Although certain major decisions should require the consent of the public partner, in general, the private partner should have broad discretion over regular decisions regarding the management of the PPIF's assets. This is an additional reason for the public partner to consider carefully the credentials of the private partner when awarding a bid (price is just one consideration). The PPIF agreements must clearly delineate what types of actions would cause a default (and consequent loss of management rights) by the private partner.

Disposition of assets: Assuming relatively equal equity contributions by both public and private partners, interests should be aligned with regard to disposition of assets. However, assets will likely be disposed of in phases, making it more difficult to assess the implications of a particular disposition. While the private partner should have the ability to recommend asset dispositions, the public partner should retain limited veto rights where the public partner reasonably believes that a particular disposition would jeopardize the return objectives of the overall investment.

Cherry Picking: A related concern is that the private partner could seek to cause the PPIF to dispose of the most marketable assets quickly (securing a substantial return on higher-value assets) and walk away from the PPIF when only the more troubled assets remain.

Transfer of interests: Discussed above.

Partnership expenses/capital calls: Discussed above. Mechanisms for the payment and reimbursement of regular and extraordinary expenses must be set out in the PPIF agreements.

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?

<u>*Comment*</u>*: The private partner bid should include information on asset management, which is a factor to be considered by the FDIC in awarding a bid. The PPIF must retain the asset manager identified in the bid package. Any future change of asset manager by the private partner would require the consent of the public partner. The public partner must retain the right to cause the PPIF to change asset managers under certain circumstances. Presumably, the FDIC will also be conducting periodic reviews of the risk exposure (via the loan guarantees); a review of asset management should be part of this process and built into the cost of the annual guarantee fee.*

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?

<u>*Comment*</u>*: Assets should be sold on a servicing-released basis. However, to avoid unnecessary disruption to the underlying assets, the selling bank should be required to continue to service the loans for a fee which would be stated in the bid package. The PPIF could elect to retain the selling bank's servicing arrangement for the specified cost or transfer servicing to another "qualified servicer" (criteria to be set forth in the PPIF agreements, taking into consideration the underlying asset characteristics).*

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?

<u>*Comment*</u>*: Data used by the independent valuation consultant, as well as results of such consultant's analysis, should be made available to potential bidders. Transparency is key and this would seem to be a useful piece of information for bidders to consider. The concern with making such information available to potential sellers is that they might elect not to sell the assets based on this information, which is fine as long as the cost of obtaining the independent valuation is passed on to the bank if no sale occurs.*