Legacy Loan Program

FDIC Request for Comment

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?

    1. Our focus is primarily on commercial real estate and thus we would be interested in al commercial real estate- related assets, including acquisition and development, construction, and term loans as well as real estate owned.

    2. Legacy assets are of greater interest given need to restore confidence for investors, depositors and counterparties.

    3. Pools of generally like kind assets would be more interesting (i.e., commercial vs. residential, cash flowing vs. non cash flowing, performing vs. non-performing, etc.) as this would permit investors to select pools and risk/return profiles that are most appropriate for their investment goals and objectives.

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?

    1. Mechanisms that permit private investors to sell the positions should be incorporated into the program in order to ensure liquidity and exit strategies for investors. Given the degree of FDIC sponsored leverage associated with the program, financing of investor positions should be avoided.

    2. Concept of qualified transferee provisions is acceptable provided they are reasonable. Market standard provisions such as demonstrated experience, financially stability, etc., that are broad enough to capture a wide range of potential secondary buyers would be reasonable.

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?

    1. Public equity participation should be limited to 50% to ensure private parties control (subject to reasonable oversight rights by public parties). Consider 51/49 private/public split for avoidance of doubt.

2. Public participation beyond 50% would be problematic if it diminishes private investor control rights.

3. Varied public participation shares might work but would depend upon specifics. A standard sharing ratio (i.e., 50/50) applied to all PPIFs regardless of portfolio composition would ensure uniformity avoid debates over definitions, etc.

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

   1. No. However, thought should be given to reporting obligations. Consider a regime whereby disclosure is limited to controlling investors and investors greater than 10% (by way of example) of the contributed private capital rather than all investors.

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?

   1. By providing investors with a broad range of product types and portfolio sizing. Consider portfolios as small as $500 million to maximize opportunities for investor participation (i.e., $40 million private equity investment). To maximize investor participation, emphasis should be placed on establishing clarity regarding requirements to qualify as a private investor, clarity regarding the auction process, clarity with regard to FDIC leverage ratio, and clarity regarding pricing of FDIC guarantees, etc. Thought should be given to the guidelines for evaluating competitive bids such that buyer qualifications and ability to perform are considered as well as pricing.

   2. Allowing sellers to reject high bids or accept lower bids offered by more qualified buyers would encourage seller participation. However, target prices should be established to manage expectations, so that buyers can evaluate merits of expending resources (time, money) vs. risk seller's might not accept offered prices. Sellers have voiced concerns about mark-to-market implications on non-auctioned assets as a result of pricing indications on auctioned assets. These concerns will need to be addressed to ensure active seller participation in the program.

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?

   1. Sealed bid.

    2. Auctions should be for entire pools to ensure equitable comparison of competitive bids. Permitting investors to bid on sub-sets of each pool or to kick-out assets would complicate auction process and raise doubts as to equitable comparisons. Smaller pools avoids need to do this.

    3. Buyers need to control selection and oversight of asset managers and servicers. Auctioning pools subject to designated asset management or servicing contracts would reduce attractiveness of a pool and could potentially make a pool uninteresting for purchase. FDIC and Treasury must establish clear standards for asset managers and servicers.

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

    1. Within the commercial real estate sector, portfolios of performing, cash flowing assets would be most interesting for initial auctions. Later auctions should include non-cash flowing and/or non-performing assets as well.

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

    1. Loan pools with a minimum size as low as $500 million (i.e, $40 million equity check) should be considered to maximize buyer and seller participation.

    2. Focus should be on auctioning of like-kind assets (i.e., commercial separate from residential, cash flowing separate from non-cash flowing, performing separate from non-performing, etc.). This will enable investors to bid for pools in line with their investment objectives.

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?

    1. All terms of the note should be defined in the offering package to ensure a fair auction given financing is integrated into the program. Emphasis should be given to ensuring that financing is provided at least through the outside maturity date of loans within each loan pool with reasonable rights of extension to permit longer-term workouts of loans that do not payoff by these maturity dates. As well, repayment terms should not require full amortization following sale of assets within each portfolio in order to avoid accelerated deleveraging of the equity positions; instead, reasonable release prices should be established.

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?

1. Seller financing would seem critical to success of the program at this time given debt illiquidity in the marketplace. This also seems appropriate from a public policy standpoint, i.e., sellers should continue to have a risk position in the assets being sold.

2. Public debt makes sense as a mechanism for investors to replace seller financing once liquidity returns to the marketplace. This should not be government guaranteed since do so would expand public subsidy to private (debt) investors. If FDIC would like to encourage public financing markets as an alternate to the guaranteed seller paper, FDIC can explore this separately.

3. Seller financing is preferable to public debt. Particular area of concern is the ability of borrowers to work with lenders to address any potential required loan administration issues or modifications in an efficient manner. Recent experiences dealing with CMBS-type loans indicates more complex structures with multiple lenders/investors and/or rigid servicing guidelines limits the flexibility of public debt, increases inefficiencies, and raises administrative costs.

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?

    1. Yes. And the fee should be established in the offering package prior to the auction. Step downs in the fee should be considered based upon demonstrable factors indicating reductions in risk (debt amortization, performance of the underlying collateral, etc.).

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?

    1. No. Public funds already participating in upside via 50% equity co-invest. Providing additional profit participation would increase cost of equity and thus constrain bid pricing. Pari passu sharing also keeps things simple and minimizes risk of conflicts.

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?

    1. Yes.

    2. Offering by syndicates should be treated no differently than single seller pools. For example, without a mechanism for kicking out assets or subdividing the pool. All or nothing. Buyers should be informed in

offering packages how sell/hold decisions will be governed by seller syndicates.

3. Smaller pools will permit smaller institutions to participate. So will permitting smaller institutions to participate in multi-seller syndicates.

4. Sellers should agree amongst themselves a mechanism for allocation of proceeds within a combined pool at the time the decision is made to offer assets on a joint basis.

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?

    1. To the extent multiple private investors participate within a single PPIP, conflicts may develop to the extent interests are not perfectly aligned. For example, if certain classes of investors have a distribution preference based on the performance of the investment. Similarly, conflicts may develop to the extent the servicer and/or asset manager for each PPIP is affiliated with the (or one of the) private investors. Examples of these potential conflicts can be observed within CMBS structures today.

    2. Conflict related concerns among private investors should be addressed by the private investors within their partnership agreements (without the involvement of public entities). To minimize conflicts between public and private investors, distributions should be established on a pari passu basis (no prefs or promotes) and guidelines should be clear regarding the authority within each public/private venture. As relates to possible conflicts between asset managers and/or servicers on the one hand and the various equity investors on the other, guidelines should be clear that both asset managers and servicers are fiduciaries of the controlling party within each PPIP (i.e., the controlling private investor) rather than the FDIC or Treasury. To the extent FDIC (as loan guarantor) or Treasury (as co-investor) are concerned about decision-making and the actions of the PPIP, FDIC and Treasury should look to the controlling investor as their fiduciary (rather than the servicer or the asset manager).

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?

    1. Buyers should have absolute discretion regarding selection and oversight of asset managers provided that asset managers meet the qualifications established by the FDIC and Treasury.

    2. Minimum criteria should be established for asset manager participation. To address fiduciary concerns, focus instead should be on establishing clear and measurable guidelines and governance provisions with the controlling investor in each PPIF.

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?

    1. Sale of assets subject to seller's ongoing servicing rights is workable however buyers will need ability to change servicing if seller/servicer fails to meet objective performance standards. These should be established in the offering package. Concurrent with performance standards, buyers will need short timeframes for seller/servicer rights of cure. Servicing fees should be established in offering packages and can be deducted from interest received on portfolio investments. For non-cash flowing pools, servicing fees will need to be incorporated into the capital structure of each PPIF or be structured on an accrual basis.

    2. Bidders on certain pools should be able to bid with and without servicing rights attached and sellers can determine the separate value of servicing and whether it would be better for them to sell a pool with or without servicing.

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?

    1. As long as target pricing is established for each auction, buyers would not need to see consultant valuations provided the amount of leverage being offered and the terms of the leverage are clearly spelled out in the offering materials for each pool.

    2. Sellers should see consultant valuations as part of process to definitively offer assets for sale.