Public-Private Investment Program for Legacy Loans
Comments to the FDIC

To whom it may concern:

Regarding the FDIC's request for public comment from parties interested in the Legacy Loan Program, please see the following responses to the specific questions posed on the FDIC's website, followed by other comments relating to the program.

By way of background, I am writing to you in my capacity as a representative of Northwood Investors, a privately-held U.S.-based real estate investment advisor with $1.25 billion of discretionary funds under management. Our investors are primarily U.S.-based educational endowments and foundations. We focus on commercial real estate investments including both equity investments and debt acquisitions. Over the last 12 months we have underwritten and reviewed in excess of $10 billion of commercial real estate loans, primarily offered for sale by U.S.-based commercial and investment banks and to a lesser extent the FDIC. Our interest in the Public-Private Investment Program for Legacy Loans is as a Private Investor considering the opportunity to invest in the equity of PPIFs comprised of commercial real estate loans.

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?

   Real estate loans comprise the overwhelming majority of troubled legacy assets on bank balance sheets, therefore we feel the program will be most effective if the FDIC takes a targeted approach and initially focuses exclusively real estate loans. Once the program is up and running, the FDIC can consider making other assets eligible for sale. Regarding the type of real estate loans that should be eligible, we feel that whole loans, B notes, mezzanine loans, loan participations and all other real estate backed credits should be eligible. This broad definition will increase the program's effectiveness. It is our recommendation that assets be grouped into pools sharing similar asset-type characteristics. For instance, commercial real estate loans should not be pooled with residential loans and large balance loans (in excess of $50 million) should not be pooled with small balance loans.

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. We believe that the ability to pledge, sell or transfer interests in the PPIF will increase the program's attractiveness for investors, thereby creating more demand and will result in achieving higher pricing for the pools at auction. By applying the same criteria required of the initial investors, the FDIC should use the concept of a "Qualified Transferee," and define at the outset the criteria that subsequent investors must meet. The FDIC should have oversight of any transfers with an approval right. Perhaps the FDIC should also assess a minor transfer fee to cover any additional administrative expenses associated with reviewing the transfer requests and granting approvals.

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?

   Recent events have made private investors very nervous about partnering with the government, given the fear that actions may be based on political motivations rather than sound economic judgment. It is our strong view that the government equity participation should not exceed 50% of the partnership's equity capital. This is based on the belief that if the government were to have a majority stake or deemed to "control" the partnership, there would be significantly less interest from the private sector to participate in the program, resulting in lower pricing for the pools at auction. There is also the potential for a moral hazard risk occurring if the government takes a higher percentage of the partnership's equity, since every additional dollar the government commits to the partnership reduces the amount of "skin in the game" required of the private investors. With less skin in the game, private investors may be willing to overpay for the loan pools knowing that the government (Treasury and FDIC) are taking almost all of the downside risk, while the private investor creates an option to share in the upside.

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

   Yes. We believe there will be more interest in the program if investors are able to remain anonymous. More interest stimulates demand and will result in achieving higher pricing for the pools at auction and ultimately more successful execution of the overall program.

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?

   To motivate private investors to participate in committing equity to the program, the FDIC should do the following:
   - Clearly lay out the terms of the partnership and "rules of the game" ahead of time and make assurances that the rules can not and will not change in the future.
   - Form pools that share similar asset-type characteristics, including: geography; collateral type; and loan size.
   - Smaller pools will encourage more investor participation by broadening the base of potential participants; however the FDIC must weight this consideration against the need to make sure that the transactions are large enough to be economically viable, given the required administration and oversight. In any event, the pool sizes should be less than $1 billion.

   To motivate banks to participate in selling assets into the program, the FDIC should structure the valuation and bidding process in a way that enables a broad range of private investors to participate, including:
   - Make the initial valuations performed by the FDIC valuation consultants available to the approved bidders (subject to standard confidentiality agreements)
   - Provide detailed due diligence material on an online "data room" that is easily accessible to approved bidders (subject to standard confidentiality agreements)
   - Provide ample time for bidders to conduct their own valuation and due diligence work
   - Encourage banks to actually sell the loan pools. If the first few auctions are rejected by the selling banks, bidders will not be willing to continue to spend time and money underwriting future pools and the program will fail.

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?

   Investor groups should be required to bid on the entire equity stake of a PPIF, otherwise uncertainty regarding control and management will complicate the process and likely reduce the pricing the auctions are able to achieve. If smaller investors would like to form bidding groups or participate with larger investors, those arrangements can be made ahead of the auction process.

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

   The FDIC should consider starting with one pool of residential mortgages, one pool of small balance commercial real estate loans and one pool of large balance commercial real estate loans. This will attract a broad range of potential investors and allow them to focus on the specific asset types in which they are most interested. To reiterate, smaller pools (less than $1 billion) will likely encourage more investor participation by broadening the base of potential participants.

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

   Size: Pool sizes should be less than $1 billion to generate the most demand. Larger pools will require in excess of $100 million of private investor equity, which may significantly limit the number of qualified participants. Also, larger pools will be more challenging to underwrite, which will lead private investors to make more conservative assumptions and result in lower pricing for the pools at auction.

Characteristics: It is our recommendation that assets be grouped into pools sharing similar asset-type characteristics. For instance, commercial real estate loans should not be pooled with residential loans and large balance loans (in excess of $50 million) should not be pooled with small balance loans. Geographic considerations are likely to be more important for residential pools and small balance commercial loans.

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?

   All of the terms of the note and its rate structure must be laid out ahead of the auction process. The terms are essential to the private investor's valuation and decision making. Specifically, the maturity date of the notes should be two years after the maturity of the longest dated underlying loan. This extra duration is necessary to allow for the possibility of extended workouts of problematic loans. The interest on the note should correspond to the type of underlying collateral (i.e. fixed rate loans should be financed with fixed rate notes and floating rate loans should be financed with floating rate notes). The interest rate should be clearly stated and the repayment terms should be provided.

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?

    We feel strongly that the selling bank should take a note back from the PPIF rather than the PPIF having to go into the capital markets to issue debt publicly in order to pay cash to the selling bank. Ultimately, all FDIC guaranteed notes, regardless of the characteristics of the individual pools that issues them, have the same credit support and will be valued as "FDIC Guaranteed Notes" rather than "PPIF 1 Debt" or "PPIF 2 Debt". Requiring each PPIF to distribute what is ultimately a homogeneous security would be inefficient.

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?

    No. The FDIC has previously stated that the leverage ratio offered with each pool will be based on the characteristics and risks associated with the pool's collateral; therefore no further adjustment to the fee itself would be necessary as riskier pools would have less debt.

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?

    No. Private investors and the government should share pro rata according to their equity contributions. To the extent the government shares disproportionately in the upside of the higher risk / higher return investments, it will discourage private investors from bidding on those pools and impair the entire program's effectiveness of dealing with the more troubled assets.

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?

    We are indifferent to where the loans come from. This is a question better answered by the banks.

Regarding the cash flow waterfall used to distribute interest income and principal repayments, our view is that the structure should generally follow the approach of pooled structured transactions where current cash flow is distributed to the equity participants on a pro-rata basis after paying management fees, servicing fees, debt service and refunding the noteholders for any realized losses based on an over-collateralization test which maintains a constant “haircut” level (as determined by the purchase price of the loan pool and leverage provided at the origination of the PPIF). Following a principal repayment event, a similar waterfall would be in place where proceeds first refund the noteholders for any realized losses and then are distributed pro-rata between the debt and the equity in proportions that maintain a constant “haircut” level.

Thank you for the opportunity to make comments on this program. Please feel free to contact me either by phone or email if you would like any clarifications.

Sincerely,
Hunt Doering