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To: LLPComments
Subject: Legacy Loans Program Comments from Erik Rand @ Stifel Nicolaus

Request for Comment

The FDIC is requesting comment from interested parties on all aspects of the proposed LLP. In particular it has formulated the following questions for interested parties to consider:

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? There's no reason to specifically exclude any items from the program. However, there are certain types of loan portfolios where the pricing will be dramatically improved by the LLP and others where the effects will be very modest. E.G. Performing resi: biggest help, nonperforming ADC: least help. Specifically, the longer the weighted average life of the asset, the more the addition of financing will improve the price.

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? The most important aspect to safeguarding the FDIC's investment is the quality and financial strength of the servicer. The owner of the underlying assets isn't particularly important and a secondary market in the structured loan pools might be useful, especially in anticipation of winding down the deals at a later date. However, the FDIC should retain the right to approve new servicers and/or replace underperforming servicers, as well as approve new owners. Note that any asset sale must incorporate the assumption of any collateralized financing associated with the assets.

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? The percentage of the government's equity is relatively unimportant. If anything, the bias from the investor community will be to have the smallest government equity participation possible. The reason is that the investor community is looking to put the most dollars to work for the highest return possible. Government participation on the equity side dilutes the amount of private dollars that get invested without reducing the amount of due diligence and labor. For example, if the government invests 50/50 in the equity, then each unit of "work" put in by the investor only yields 50% of the equity invested. However, this is relatively unimportant to the pricing. In contrast, the amount of financing provided will have a dramatic impact on price, especially for longer term assets.

4. Is there any reason that investors' identities should not be made publicly available? Some investors like to fly below the radar screen. For example, one potential investor in the FDIC pool purchased by PNMAC in December was so threatened by the amount of publicity generated around the deal that they will sit out from future deals if it will require the parent company's name to be in a press release.

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? The FDIC must assure sellers provide a specific reserve price to all potential bidders prior to due diligence. The most important

thing to do is to contractually obligate sellers to sell if a mutually agreed on reserve price is met or exceeded through the bidding process.

Potential sellers will likely flood the FDIC at the onset. To get the ball rolling, a series of large and relatively "easy" transactions should be targeted, with the more complicated deals following after the program has demonstrated success. The vetting process for deals should include: 1) size (the deal has to be large enough for the FDIC to have a bond issuance on the funding side) and 2) price: a reserve price must be contractually agreed on whereby the seller is obligated to sell if the reserve price is met (see details in question 6).

6. What type of auction process facilitates the broadest investor participation? These are going to be very large deals requiring multi-million dollar due diligence investments by the potential investors. Even though the winning bidder may only be putting 5 or 10% equity into the pool, the vast majority will be performing due diligence of 100% of the pool. The auction process should be a two step process. In the first round, the loan portfolio should be broadly marketed to determine a reserve price defined as follows: Investors would be required to submit a reserve price level (based on leverage assumptions provided by the FDIC) whereby they would be willing to be one of three parties invited to perform due diligence on the portfolio for a final bid. Due Diligence costs would not be reimbursable. However, due diligence would not commence unless the seller contractually agreed to sell the portfolio if a reserve price was met or exceeded, and if 3 investors could be found to due diligence the pool based on the reserve price. Upon completion of due diligence, the second and final bidding round would take place and the loan portfolio sold and closed with the highest bidder, as long as the reserve price was met or exceeded. 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? Investors should be required to bid on the entire stake. If investors can bid on tiny partial stakes, you could have a situation where an investor gambles (by skipping due diligence), overpays, and causes the government a massive loss. However, if investors are on the hook for due diligence costs, the likelihood of accurate and serious bids is much higher. 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? An auction could only be reasonably run after investors had completed due diligence. I don't think investors will complete due diligence unless they know a transaction will take place at a certain minimal level. If enough investors complete due diligence, a Dutch auction would be harmless, but the likelihood of having sufficient investors if low. If multiple investors are allowed to bid through a Dutch auction, or similar process, how should asset management control be determined? Investors must be vetted prior to initiating due diligence. Unqualified investors (because of the asset management angle) should be discouraged from bidding if they won't be allowed to buy the portfolio.

7. What priorities (i.e., types of assets) should the FDIC consider in deciding which pools to set for the initial PPIF auctions? Performing residential and commercial loan portfolios should be used for the initial PPIF auctions. There are two main reasons for low prices in today's market. The first reason is deteriorating credit and declining property values. Investors price in expected losses. The second reason is lack of leverage. The typical yield requirement for hedge and equity investors is 18%+. When pricing performing loans with coupons in the 6-7% range and 10 to 30 year maturities, this creates huge discounts. The shorter the maturity, the less the required discount. The longer the maturity, the greater the discount. By providing more leverage, the FDIC can improve the pricing. Therefore, the PPIF should focus on the assets where it will have the biggest impact on pricing and thus the highest likelihood of effecting loan sales.

8. What are the optimal size and characteristics of a pool for a PPIF? There will probably be widespread investor interest in pool sizes ranging from tiny ($50 million and less) to huge, $5 billion and more. The single most important aspect of a successful loan sale under the LLP will be setting and agreeing to a reserve price. In general, it would be helpful to separate asset classes like residential, commercial and consumer loans, and performance (no delinquencies) vs. scratch and dent vs. non-performing. In some cases, fixed vs. ARM may be a useful distinction. And for commercial loans, a separation of credit tenant deals from smaller loans. ADC loans need to be in their own pools.

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 the note and rate structures for the leverage are essential. The more vague / volatile they are, the less benefit to the price the leverage will provide. How about the opposite…match the note and rate structure to the pool and its performance? For example, the rate on the note would be the WAC on the pool minus 3%, and the term would be variable but fully amortizing based on the pools cash flows? That would maximize price.

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? If the note that the bank took was very liquid, that would improve their flexibility down the road. Better to have more options than not, but it would probably serve the market better to have all the PPIF notes trading periodically (with a liquid and transparent secondary market) than being put in banks' portfolios and potentially becoming Level 2 or Level 3 assets. 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? Public issuance is the best option because it is transparent. If the program works, it will provide the most liquidity with the fewest unknowns. Would a public issuance of debt by the PPIF limit its flexibility compared to the issuance of a note to a selling bank? If a bank sells through the PPIF and eventually fails anyways, the FDIC will be better off if the PPIF is funded through a public issuance than if the FDIC needs to re-sell the note the selling bank took back on its books.

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? It depends. Presumably, the underlying risk characteristics will have been properly accounted for in the purchase price. How would the FDIC (or anyone else) more accurately judge the potential for losses better than the gauge represented by a competitive bid? If anything, the guarantee should be adjusted for duration. A higher percentage guarantee fee for short duration pools seems to make sense (think non-performing ADC loans) because there is more room for costly mistakes and more motivation for market manipulation. For example, a seller could stick the PPIF with a huge loss if it could get an investor to massively overpay for a non-performing pool. Perhaps a formula using discount percentage and duration would make sense.

12. Should the program include provisions under which the government would increase its participation in any investment returns that exceed a specified trigger level? No, there is already an implied benefit in the continuous receipt of the guarantee fee on the debt issuance. Excessive gains will most likely be found in the lowest priced and riskiest deals (like ADC deals). Since the riskiest deals will tend to have the shortest durations, the guarantee fees for issuances supported by such deals should be the highest. If so, what would be the appropriate level and how should that participation be structured? Presumably, the government as a side by side partner with the equity investor would reap the same benefit as the investor. The FDIC will set the leverage and guarantee fee

percent so the FDIC should be reasonably well protected. Also, since the sellers must agree to the price, it is unlikely that there will be too much upside.

13. Should the program permit multiple selling banks to pool assets for sale? Yes, but not initially. This will be a distinct benefit to the smaller banks once implemented. However, it adds multiple levels of complexity to any transaction. Multiple banks would have to agree to multiple reserve prices (think: herding cats). The key is to have a series of successful transactions at the start. Failed transactions (meaning investors perform due diligence but no transaction takes place) will have a detrimental effect on the PPIF. In fact, the broad success achieved by the FDIC through receivership and the subsequent liquidation of assets is due in part to the fact that the market believes that a sale will ALWAYS take place. Investors don't mind performing due diligence and subsequently losing competitive bids. They will boycott altogether if there are a series of "no-trades". If so, what constraints should be applied to such pooling arrangements? Like products should be put together. The more varied the maturities, the more potential issues on the bond issuance side. How can the PPIF structure equitably accommodate participation by smaller institutions? The PPIF should have a separate smaller institutions group. The market will have plenty of appetite for small pools as there are plenty of small investors. The mechanics are the same either way. But the potential investors will vary by asset class and pool / deal size. Under what process would proceeds be allocated to selling banks if they pool assets? Loans and reserve prices should be set by pool and separated by institution. Investors will have no problem providing pricing on a pool broken down by selling institution.

14. What are the potential conflicts which could arise among LLP participants? The biggest potential issue is for an investor to have undisclosed ties to a seller. What structural arrangements and safeguards should the FDIC put into place to address or mitigate those concerns? When vetting investors for the asset management capabilities, their owners and material investors must be disclosed. The FDIC must have authority to exclude investors on these grounds. For example, suppose ABC bank has an equity investment in XYZ hedge fund for $10 million. Suppose ABC decides to sell $100 million of construction loans using the PPIF, and that the PPIF market price would be 25 cents which would equate to a $5 million investment by the winning bidder (assuming $5 matching equity and 3:1 leverage). If ABC tells XYZ to bid 50 cents, XYZ would have an equity investment of $10 million, plus 3:1 leverage ($30) plus $10 matching = $50, so it would cost $5 in purchase price to save $25 in losses for ABC…

15. What should the relative role of the government and private sector be in the selection and oversight of asset managers? The investor in the loans (not the FDIC bonds) should be (or select) the asset manager but the FDIC must vet the asset manager prior to allowing an investor to bid, and the FDIC must have the right to remove the asset manager for cause. 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? The FDIC would be well advised to hire a specialty master servicer. The Master Servicer would collect all remittances from all the asset managers and remit the same to the FDIC. The Master Servicer would have the responsibility to oversee and pay attention to the performance of every deal, and subsequently notify the FDIC at the first sign of trouble. The FDIC should hire separate (and unaffiliated) special servicers to take over servicing/asset management for troubled deals.

16. How should on-going servicing requirements of underlying assets be sold to a PPIF and paid for? The servicing fees should be discussed, proposed and agreed on using the process described in 6 above and they should be set and agreed on before final bidding. Should value be separately attributed to control of the servicing rights? Servicing rights always have an economic impact, but sometimes it's negative, not positive. The

servicing rights must be valued on a case by case basis. There's probably no benefit to pricing and trading the servicing separately from the underlying loans in this environment.

17. Should data used by the independent valuation consultant, as well as results of such consultant's analysis, be made available to potential bidders? The true value of the independent consultant is to properly manage the expectations of the selling institution so that a successful transaction occurs. Investors need all the information available about the assets being sold, but the specifics on the consultant's valuation won't be very important to them. Qualified investors will perform their own due diligence and make their own assessment of value. The only thing they'll want from the consultant is the answer to the following: what's the lowest price that I can win this pool at? Should it be made available to potential sellers prior to their decision to submit assets to bid? See number 6 above. The most important thing is to set a contractually obligated reserve price: The seller must sell if the agreed on reserve price is hit or improved on.

18. Purchase and Sale Agreements: The FDIC typically sells loan portfolios with limited Reps and Warrants. However, the higher an asset prices, the more reps and warrants investors look for. Another key factor in the success of the PPIF is the successful negotiation of the Purchase and Sale Agreement, for EACH transaction. The FDIC should start with a template P&S which potential sellers must review and agree to prior to the start of any potential transaction. The P&S needs to contain substantially full reps and warrants. THE FDIC MUST DECIDE IF THEY INTEND TO BACKSTOP THE REPS AND WARRANTS IN THE EVENT OF A SELLER FAILURE. The P&S should be submitted to the investor group prior to the commencement of due diligence. All investors performing due diligence in competition should agree to take on the burden of a successful P&S negotiation with the full knowledge that regardless of being the winning bidder, if they can't agree on the P&S, they won't win the transaction.

19. Other buyers. It is likely that the best bid in the market place will come from another bank, not a hedge fund etc. participating in the PPIF program. Healthy banks still have more leverage available to them than that proposed by the PPIF. The PPIF should not risk hurting pricing by excluding buyers that do not wish to accept both equity and leverage.

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