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Delivered via e-mail, to LLPComments@FDIC.gov, and by U.S. Mail

Robert E. Feldman
Executive Secretary
Attn: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Legacy Loans Program

Dear Mr. Feldman,

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the Legacy Loans Program (LLP) recently proposed by the United States Department of the Treasury (Treasury) and the Federal Deposit Insurance Corporation (FDIC). The announced intention of this program is to "cleanse bank balance sheets of distressed loans and other assets and reduce the associated market overhang…."[2] The LLP seeks to accomplish this by providing financing to private investors, through equity investments by Treasury and debt guarantees by the FDIC, that the government hopes will be sufficiently attractive to close the gaps between what buyers have been willing to pay and what sellers have been willing to accept for these assets.

The ABA appreciates the efforts of Treasury and the FDIC to help banks address the challenges involved with the management of troubled assets. While the decision of whether to participate in the program is one that must be made by each bank, we believe that several issues need to be resolved before the LLP is implemented in order to maximize the program's possible utility. These issues include the following:

[1] The ABA brings together banks of all sizes and charters into one association. The ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $14 trillion in assets and employ more than two million men and women.

[2] Public-Private Investment Program for Legacy Loans Frequently Asked Questions (LLP FAQs, available at http://www.fdic.gov/llp/LLPfaq.pdf).

- Bank eligibility. The government must avoid creating a program that will benefit one category of banks at the expense of others. Treasury and the FDIC should look for ways to ensure that all banks that choose to participate can do so, including community banks who may want to sell only a few assets through the LLP. This may require the creation of multiple-seller pools of assets.

- Asset eligibility. The LLP should be available for a broader range of assets than just residential and commercial mortgage loans, as is currently contemplated. For instance, trust preferred securities, all real estate-related loans, and "real estate owned" (REO) assets should be eligible for inclusion in the LLP.

- Payment of FDIC costs. As the FDIC expands its view of what is an appropriate exercise of its "systemic risk" authority,[3] the FDIC should seek to recover any losses incurred as a result of its guarantee from those who benefit directly.

- Banks as buyers. Banks should have the opportunity to purchase assets from other financial institutions through this program.

These and other points are discussed more fully below.

Bank eligibility

The FDIC has stressed in its communications with the industry that the LLP will be available to all banks.[4] We support this focus on the need to ensure that the government's stimulus proposals are implemented in an equitable manner and that the government avoids creating winners and losers by virtue of these programs.

However, the FDIC also has indicated that it intends to use single-seller pools at least initially, whereby the FDIC would create a pool of loans from only one bank. This means one of two things: either the FDIC is prepared to offer very many and very small pools of loans, or those banks that do not want to, or cannot, sell many loans will find themselves shut out of the program. The former alternative may be cost-prohibitive, while the latter alternative certainly would be unfair.

A middle ground would be to create multiple-seller pools. This would enable the FDIC to spread the costs associated with the formation and management of any one public-private investment fund over enough loans to make the program feasible to all banks.

We recognize that multiple-seller pools may create other issues, including how to resolve disagreements between potential sellers regarding whether a bid is acceptable and how to conduct due diligence efficiently when loans from several banks are offered. It is likely that many of these issues could be addressed at the pool formation stage, where the FDIC perhaps

[3] 12 U.S.C. § 1823(c)(4)(G).

[4] *See*, *e.g.*, Transcript of the Conference Call for Bankers ("Transcript"), available at http://www.fdic.gov/llp/transcript033009.html (quoting FDIC Chairman Sheila Bair: "…I want to re-emphasize that all banks will be able to participate in this program, large and small.").

could match loans from banks that are willing to sell loans with similar characteristics and accept a comparable percentage of aggregate book value. Proceeds generated from a sale of pooled loans perhaps could be allocated to the participating banks on a *pro rata* basis (*i.e.*, a bank contributing loans with a book value of $60 in a $100 pool would receive 60% of the proceeds). Moreover, the FDIC could devise efficient due diligence procedures that make information about a pool available electronically or at a centralized location in order to minimize the burdens associated with reviewing a pool's assets prior to bidding. In short, given the close involvement of the government that already is contemplated in the pool formations, the issues surrounding the formation of multiple-seller pools appear to be surmountable.

Eligible assets

The FDIC has stated that it intends to focus, at least initially, on the sale of loans secured by mortgages on residential or commercial real estate. We agree that these asset categories are very important for many banks. However, there are several other asset categories that are for some banks as important or more so, and we urge the FDIC to open the LLP to additional asset categories.

Trust preferred securities (TPS) represent one class of assets that is particularly problematic for many banks. Until recently, the issuance of TPS was seen as a cost-effective way for bank holding companies to raise capital. As of December 31, 2008, almost 1,400 bank holding companies had approximately $148.8 billion in outstanding TPS.[5] However, many TPS have been downgraded due to the performance of the companies that sold the securities. Our members tell us that there is a significant liquidity discount associated with TPS in general, as potential buyers are unwilling to purchase these securities except at a steep discount. However, as the industry recovers, the underlying value of the TPS should return. The LLP, which is intended to enable buyers and sellers to overcome the problems arising from a liquidity discount, could help buyers and sellers overcome these same problems with TPS.

We also recommend that the LLP be expanded to include additional real estate-related loans, such as those secured by farm land. The issues surrounding the formation of a pool of loans secured by farm land would appear to present challenges that are roughly comparable to those presented by forming pools of loans secured by residential or commercial real estate. While we appreciate the benefits of gaining experience with a program before expanding its scope, we are concerned that failing to include loans secured by farm land could result in the government indirectly selecting winners and losers.

A third type of asset that our members have identified as potentially helpful to include in the LLP is REO property. The amount of REO is increasing as more loans go into default and more property is placed on the market for sale. The LLP structure could provide relief by creating incentives for more potential buyers to bid on these properties and thereby counteract the downward pressures on real estate prices.

[5] J. Salutric, Surveillance Specialist, and J. Willcox, Manager, Federal Reserve Bank of Philadelphia, "Emerging Issues Regarding Trust Preferred Securities," available at http://www.philadelphiafed.org/bank-resources/publications/src-insights/2009/first-quarter/q1si4_09.cfm.

Payment of FDIC costs

We note at the outset of the discussion about costs the growing concern on the part of many in the industry about the FDIC's "mission creep." The FDIC must not allow itself to become extended in activities beyond its traditional role of deposit insurer that in any way detract from – or, equally problematic, are perceived to detract from – its primary and paramount deposit insurance responsibilities.

The systemic risk authority that the FDIC appears to be relying on for the LLP authorizes the FDIC to act irrespective of the statutory mandate to resolve institutions in the manner that is least costly to the Deposit Insurance Fund (DIF). It is by no means obvious that this authority is sufficiently broad to support the stimulus activities that the FDIC is offering or proposes to offer. However, assuming that the FDIC implements the LLP, it is vitally important that the DIF not be put at risk to support this or other stimulus proposals.

The FDIC has suggested that it expects not to incur a loss stemming from its guarantee of debt used to acquire assets through the LLP. As explained by the FDIC, the assets likely will be sold at a discount to their book value, which increases the buyer's chances of earning a profit on the assets. Moreover, there will be at least approximately 15% equity in each asset purchased provided by Treasury and private investors that will absorb losses before the FDIC's guarantee is triggered, and the FDIC will receive a risk-based fee in return for its guarantee. However, should the FDIC incur a loss, its current plan is to recover that loss through a "systemic risk" assessment (*i.e.*, an assessment based on total assets as opposed to total deposits) on the banking industry.

There is a growing frustration on the part of many banks of all sizes about the FDIC asking institutions that choose not to participate in the FDIC's expanding stimulus programs to be placed at risk of paying for their losses. There are banks that will elect not to participate in the LLP because they do not need to or wish to. Many of these banks feel very strongly that they should not be saddled with a special assessment to pay for the actions of others. It bears repeating that the DIF must be preserved and the activities and obligations of the LLP carefully sequestered from the DIF. Having said that, it is appropriate for excess revenues from the LLP to be placed in the DIF since all banks participating in the LLP also are participants in the coverage of the DIF separately from the LLP.

Banks as buyers

Banks should have the opportunity to participate in the LLP both as sellers of assets and as purchasers. The objectives of the program would be advanced by increasing the pool of bidders, as more bidders means a greater likelihood that pools will be sold. The LLP is designed to benefit banks by enabling them to sell assets unencumbered by a liquidity discount. To do so, the government is creating opportunities for buyers to profit. While some have expressed reservations about permitting banks to profit by purchasing assets through the LLP, it would be curious to hamper a program designed to benefit banks because of a concern that banks would benefit.

Others have suggested that the LLP should not be used to shuffle bad assets from one bank to another. Such a concern misses the point of the LLP. As previously noted, this program is premised on the idea that banks hold assets that have an embedded liquidity discount. The LLP is designed to provide the lubricant to overcome the current friction created by this discount. Assuming the value in the assets being sold will in time exceed what buyers would pay today without the LLP, the program provides an opportunity for buyers to acquire assets that will be profitable over the long term. Thus, the LLP, if it functions as intended, will jumpstart the market and in so doing benefit all participants.

Furthermore, it is entirely conceivable, and desirable, that banks would see the opportunity to use this facility to improve the diversification in their portfolio, in essence trading excess exposure in a set of assets with another bank seeking to reduce exposure in a different set of assets. For example, a bank with too much exposure in one geographical area could sell some of those assets and replace them by purchasing through the program assets from a different geographical area from another bank seeking to reduce its geographical concentration. Both banks would be safer with the improved diversification in portfolio.

<u>Other issues</u>

Form of consideration. The Summary of Terms for the LLP states that "[c]onsideration paid to Participant Banks in exchange for purchased Eligible Asset Pools will be in the form of cash or cash and debt issued by the PPIF [*i.e.*, the public-private investment fund]." In a subsequent conference call with bankers, Chairman Bair left open the possibility that a selling bank could take an equity interest in the PPIF.[6] We believe the program is likely to attract considerably more interest from banks seeking to sell assets if they can participate in whatever profits are realized by a PPIF. The liquidity discount that has prompted the creation of the LLP stems from the fact that many banks believe the loans on their books are worth more than investors are willing to pay. These banks may be more willing to sell at what they view as a steep discount if they are in a position to benefit from the eventual return of what they believe is the real value of the assets being sold.

The FDIC also invites comment on whether it would be preferable for a PPIF to give the selling bank a note from the PPIF in exchange for the pool of assets the bank sells or to give the selling bank cash (presumably the sum of the equity contributions of Treasury and the investor and the proceeds of FDIC-guaranteed debt issued by the PPIF to third parties). We believe that the parties should have the maximum flexibility to structure the payment to the seller in the way deemed best by the parties. While a seller likely would prefer cash as a general matter, there may be circumstances when a note would be preferable, including situations where the transaction otherwise would not close.

If a selling bank takes back an FDIC-guaranteed note as consideration, that note should receive a zero risk weighting under the risk-based capital rules if, as the FDIC has asserted in

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[6] *See* Transcript, *supra* ("I think there was some discussion about whether selling banks should be able to take part of the payment back as an equity interest in the PPIF, the bidding on -- the selling banks will have assets. So, I think we'd be open to comment on that. And if you think that's something selling banks would be interested in, we'd be open to comment on that.").

connection with other FDIC guarantees,[7] the full faith and credit of the United States Government stands behind the guarantee.[8]

Encouraging new capital to invest in the industry. The materials published by the FDIC announcing the LLP were clear that affiliates of a bank would not be eligible to purchase assets from that bank. Thus, for instance, a bank holding company would be prohibited from using the LLP to purchase loans from its subsidiary bank. The reasoning behind this prohibition seems to arise out of a desire to have an arms-length transaction that avoids the appearance of unjustly enriching a consolidated entity through the sale of troubled assets by a bank to an affiliate that is using the government's assistance.

We suggest that the FDIC leave room to consider situations where affiliate transactions may be appropriate. One scenario where this may be the case involves the injection of new capital into a bank's parent bank holding company. In this scenario, a bank may be able to attract a new investor to contribute capital to its parent (with the capital being downstreamed to the bank) if the prospective investor knows that the holding company would be permitted to invest in a PPIF that purchases the bank's loans. By using the process contemplated by the FDIC, the holding company would still need to be the winning bidder in an auction, thus minimizing the risk of an affiliate obtaining assets at below-market prices. This could present a way for some institutions to shore up capital while cleaning up their balance sheets at the same time. Moreover, it might prevent some failures that otherwise could lead to far more expensive resolutions for the FDIC. Thus, we urge the FDIC to leave open the possibility for a bank holding company, through a PPIF, to acquire loans from its subsidiary bank if the purchase is coupled with the contribution of a significant amount of new capital in the holding company and the FDIC is satisfied that the transaction is sufficiently at arm's length.

Certainty of terms. An issue that plagues all recently-announced government stimulus initiatives is the uncertainty of whether participants will be subject to the restrictions that apply to banks that participate in, for instance, the Treasury Department's Capital Assistance Program.[9] Anticipating this issue, the LLP Frequently Asked Questions contains the following item:

> **Will the Legacy Loans Program be subject to executive compensation restrictions?**
> The executive compensation restrictions will not apply to passive Private Investors.[10]

[7] *See* 73 Fed. Reg. 72244 (Nov. 26, 2008) (in which the FDIC noted that the full faith and credit of the United States stands behind the FDIC's guarantee issued through the Temporary Liquidity Guarantee Program (TLGP)).

[8] We assume that the debt to be guaranteed through the LLP would be in connection with an obligation where the principal amount and term to maturity (or date of maturity) will be stated in the obligation. If that assumption is correct, the debt would appear to satisfy the requirements of 12 U.S.C. § 1825(d) for the full faith and credit of the United States to apply. While we recognize that the FDIC considered a 20 percent risk weighting appropriate for debt guaranteed under the TLGP, we respectfully submit that this is inconsistent with the FDIC's assertion that the debt is backed by the full faith and credit of the United States.

[9] *See* http://www.financialstability.gov/roadtostability/capitalassistance.html.

[10] LLP FAQs, at 3.

However, the answer, by focusing solely on the investor, only compounds the concerns about whether a bank that sells loans will be perceived as having received a "bailout" by virtue of participating in a transaction that has been facilitated by the federal government. The drafters of the FAQs simply may have assumed that no one could seriously think that banks selling loans through the LLP should be subject to the restrictions on executive compensation, dividends, and so on. In today's environment, however, banks are unwilling to participate based solely on such assumptions.

We recommend that the FDIC and Treasury explicitly and clearly state that banks that sell loans through the LLP will not, by virtue of participating in that program, be subject to any requirement imposed as a condition of participating in any other federal stimulus program.

Other qualifying criteria. In several places in the LLP materials, the FDIC observes that there will be qualifying criteria both for the loans that will be eligible for inclusion in the program and for the investors who will be eligible to purchase the loans. However, the FDIC has not yet released much information about these criteria. We suggest that the FDIC provide interested parties with the opportunity to comment on the criteria once they are developed, given the likely significance of these details to the program's ultimate success.

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The ABA appreciates the opportunity to share these thoughts about the LLP with you. While we take no position on whether any given bank should participate, we believe the changes suggested above will improve the program's chances of success.

Sincerely,

Mark J. Tenhundfeld