From: Greg Berman [mailto:g.berman1@gmail.com]
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To: LLPComments
Subject: Legacy Loans Program

I have several comments for you on the Legacy Loan Program for your review.

1. Bid Ask Spread Issue

I currently work in real estate private equity, and the fundamental reason that distressed debt is not moving off the books of these institutions is that there is a very wide bid ask spread, and I am not confident that the plan as proposed will solve that problem. Let me use a simple example to demonstrate why the spread is so wide:

-A bank made a pro forma loan on an office building up to 80% of the pro forma NOI. The base NOI was $100 and pro forma NOI was $120. The bank valued the office building at a 5 cap, meaning the building was worth $2,400 and the loan at 80% was $1,920. However, instead of going to $120, the building NOI is now $80, and valued at a now market rate of an 8 cap means the building is only worth $1000 (i.e. only 52% of the value of the loan.) On top of that, you would need to price in an investor's desired rate of return which will be above 15% annually, and you can see how the private investor would only be willing to pay something below $.50 on the dollar for the loan. Most other PE firms I correspond with on a regular basis are valuing many of these loans sub $.40. Banks currently seem to be asking $.60-$.70 on the dollar for these loans.

Fundamentally, if a private investor feels they are overpaying so significantly for a loan, I am not sure that the federal government offering leverage is going to help. Leverage is only beneficial when an investor believes that the rate of return on the investment exceeds the cost of the leverage, and when the price mismatch is so great, an investor will have to believe an extremely high level of property appreciation to feel that rate of return will exceed the leverage cost. Additionally, with 6:1 leverage, it is very easy for the equity to be wiped out with such a large mismatch in pricing expectations. As proposed, the program does not force the banks to accept a bid in an auction situation, which may preclude all but few loans from actually trading.

2. Incentive Structure

It was mentioned I believe in the conference call that the government is considering a 'reverse waterfall' structure where the government would take a larger share of the upside if the PPIF is highly successful. This structure is opposite the way almost all normal private equity deals function, and it disincentivizes the private investor from realizing the high level of returns that would both compensate them for their risk and provide a greater return to the taxpayers. The private investor's money is in the riskiest portion of the capital stack with the FDIC leverage in a senior position to the equity. If you begin to limit an investor's upside, you are likely to have less success finding program participants who are willing to take the highest risks in the deal yet not have the highest returns in the event of significant success.

Additionally, in the majority of private equity deals, the Private Investor who is managing the deal is paid an asset management fee for their time and overhead. Again, the proposed structure is opposite the normal private equity structure with the PPIF paying a fee to the FDIC for oversight.

My general comment is that I feel the Treasury and FDIC need to structure the incentives and fees to be more in line with how the investment market operates to incentivize the purchasers of the loans to both participate and maximize returns.

3. Other Proposed Solutions

First, the government must find some way to compel the banks to sell loans at market prices. I am highly concerned that this program will lead to zombie banks, and will cause many more years of pain rather than taking our medicine now. I would not want to see the US go through a similar economic situation that Japan experienced over a 10 year time period with stagnant growth due to a lack of healthy financial institutions. I feel the structure that was used with the RTC is much more likely to be effective. Although it may require additional taxpayer funds now to support some of these banks that may have to take significant write downs, I feel long term it is more likely to maximize return to the tax payers both through federal sharing in the equity returns in the PPIF, and through more rapid economic growth for the country. From my knowledge of the RTC, it appears that it was a successful endeavor form many perspectives. Why re-invent the wheel with this new program?

Second, the government may want to consider creating its own bank that would provide loans on stabilized, cash flowing properties. The owner of each property would be responsible for negotiating a payoff with their lender. This scenario is more likely to move loans at $.60-$.80 on the dollar as the current property owner has an incentive to protect their existing equity, and does not require such a steep discount to make it worth it for them to 'buy the loan'. Many properties, such as the one I used in my example, may still be able to cover debt with some level of write-down in their existing loan, but the market is not providing loans at 80% LTV at conventional rates. In my previous example, if the loan was written down to 70% of the value of the loan ($1,344), the property would still be able to cover the loan with $80 of NOI at a 5.5% rate interest only. These new loans could be sold to the market backed by a federal guarantee, with the government sweeping some amount of the interest as a guarantee fee. The rate on these loans would still be higher than current rates on treasury bonds, and with the federal guarantee would likely attract significant investor interest.

Respectfully Submitted,
Greg Berman
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