PREA pension real estate association

Legislative Alert

# FDIC REQUESTS COMMENTS ON THE LEGACY LOAN PROGRAM

**April 2, 2009**

Following up on the Treasury Department's March 23, 2009 announcement of the Public Private Investment Program ("PPIP"), the FDIC has issued a description of the Legacy Loan Program ("LLP") that is a part of the PPIP and has requested public comments on a list of questions relating to the LLP. See, *Legislative* Alert "Treasury Department New Public-Private Investment Program", March 23, 2009.

The following is a list on questions on which the FDIC is seeking public comments and the procedures for submitting comments, which are due by April 10, 2009:

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?

   All asset classes and assets should be eligible. However, banks should triage their balance sheets to take out the bottom 30%-40% of their distressed assets i.e., those loans that will sustain significant negative cash flow due to vacancy, impaired tenants, oversupplied markets, etc. and gets those into the market quickly before further value deterioration occurs.

   The FDIC should recognize that investors are generally segmented by asset class, geography and investment size/scale. Portfolios should be bundled by asset class within regions or nationally. At present, multifamily residential and office building assets in major first tier markets would be priority investments; hotel, retail and raw land will be less marketable.

2. Should the initial investors be permitted to pledge, sell or transfer their interests in a public-private investment fund ("PPIF")? If so, how should the FDIC ensure that subsequent investors meet the program's criteria for investors?

   Yes, initial investors should be permitted to sell or transfer their interests, subject to FDIC approval (not unreasonably withheld), but should not be able to pledge their interests.

   FDIC should establish crieteria for their partners/borrowers: net worth or capital should be at least 2X the loan amount, borrowers should not be in default to a TARP bank, experience in the asset class, etc. Subsequent partners (i.e., those who buy spin-off assets) should be held to same standard.

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 government equity should generally be limited to 30%. Taxpayer interest could be protected by getting a kicker after a specified return hurdle level (like 30%). For example, if the private investor puts in 70% and the FDIC 30%, they could split cash flows pari pasu up until 30%; after that the cash flow would be split 60/40 or 50/50. In this way, the private investor would still be able to make compelling risk adjusted returns, and the kicker feature would enable the FDIC to share the upside. This two tiered approach is fair and provides a win/win for both parties.

There are numerous ways to structure the cash flow waterfall. What the FDIC needs is an investment advisor that could provide the necessary technical assistence to their underwriting staff. Such advisors should be practioners and specialists with a track record in this arena (as opposed to an accounting firm or consultant with no direct transaction experience).

The FDIC should always retain the option of increasing its investment percentage (up to 50%), but should exercise this option only under extraordinary circumstances. Another alternative would involve the FDIC placing its equity in a preferred equity position and reduce their backend promote feature.

The FDIC's investment should not be restricted by the asset class but rather by the risk/reward parameters of the particular investment.

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

   The name of the investment entity, not the individual principals, should be public information.

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 needs to use the various national industry associations (ULI, NMHC, ICSC, NAIOP, etc.) to promulgate the program regulations, bid programs, coming auction schedule, etc. It also needs an interactive web site that can provide real time information and answer investor questions.

   The FDIC should retain several of the major national/international brokers (e.g., CBRE, C+W, JLL, etc.) and have them prepare bid packages, due diligence war rooms, and actually run some of the bids. Such brokers will know who the likely bidders will be and can efficiently market the pools.

   In order for the FDIC to jump start a new investor market with the brokers, they will need to actively organize the sellers and investors to elicit their participation. They need to start with a few lenders and assemble some simple "trial balloon" portfolios – like the RTC initially did – large enough and well priced so that it can attract some major private equity firms and establish a solid pricing floor for the market. By doing so, the FDIC will quickly establish the credibility of the auctions and win the endorsement of a few leading private equity thought leaders. The broader market will then follow this lead.

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?

The FDIC should allow investors to make whole or partial bids; on some portfolios, the FDIC should reserve the right to play "matchmaker" by pooling together various bidders into an investment consortium.

The FDIC should use Dutch auction process, and with multiple investors, the FDIC should reserve the right to select the asset managers based on qualifications, or simply award it to the largest investor.

Multiple auction bid formats should be used, including the sealed/silent auction, open auction (i.e. the open outcry system) and the Dutch auction method, whereby the seller effectively sets a minimum acceptable reserve price, but the auctioneer starts the bid process with a high initial asking price and prices can be accepted at any point(s) between.

Some of the asset pools could be sold in a manner similar to the Treasury's sale of government bonds. The FDIC can create a network of primary broker dealers (could be banks or brokers) who submit bids on behalf of a group of pre-registered investors. The bids are placed through an automated trading system and the winners can be determined with the hour. For large pools of securitized laons this system would work well.

Another variation of the Dutch auction process would be for the FDIC to invite banks to submit their assets to a pool that would trade within a certain specified pricing "bandwidth". The FDIC's broker agent then markets this mixed pool indicating the minimum/maximum price points. In this way bidders know in advance that there is a strike zone within which the pools will trade, and that the banks have set parameters within which the transaction pricing is acceptable. This hybrid auction mixed with a seller specified pricing range can increase the certainty of the bidding outcome. If not enough bids are submitted the banks would reserve the right to withdraw the offer.

To effectively market large asset pools – in excess of $1 billion – bidders should submit pre-qualification bid packages that enable the FDIC to guage their financial capacity. The FDIC's designated broker dealers should then undertake targeted "road shows" with the FDIC to the investors to market the portfolio. This type of information sharing session will enhance transparency and the confidence of the bidders.

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

   The initial auctions should involve multifamily or office building assets in major markets that will attract highly qualified investors, and which should be priced to ensure a successful resolution.

   The FDIC should also have bids for assets that would interest the non profit sector (e.g., 501(c) 3 community development corporations, etc.) who could take advantage of the Community Reinvestment Act, HUD programs and tax exempt financing for the low/moderate income sector that support local community development initiatives.

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

   The PPIF auctions need to embrace both small and large investors, as well as both the private and not-for-profit sectors. The FDIC should coordinate with HUD, the Commerce Department and the SBA to

tailor auction programs based on their constituencies.

Auctions could be segmented by equity size:

1) A Small Investor Program: <$20M
2) Medium Size Investor Program: $20M to $40M
3) Large Investor Program: $40M to $100M
4) Macro Investor Program: >$100M

The PPIF pools should be single asset class.

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?

   Each auction pool should stipulate the terms of the loan – the interest rate, loan to bid amount, the loan term, payment terms, funding conditions, recourse provisions, and other typical loan conditions.

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?

    Yes, the selling bank should be able to take back a note and do purchase money mortgage structures.

    The PPIF should not issue debt publicly to be able to pay cash to the selling bank.

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?

    The loan guarantee fee should be graduated to reflect what the FDIC percives to be the increased risk exposure.

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?

    As indicated in #3, the FDIC can participate in the upside by retaining an additional percentage interest over a stipulated targeted return. The cash flow waterfall and distributions should generally be standardized; the FDIC should, however, maintain the flexibility and right to put forth more creative waterfalls where significant front end risk exists but which have the potential for extraordinary gains on the backend.

    The FDIC should refrain from approaching the structures in a rigid bureaucratic manner. They should maintain a flexible position, and draw upon the experience of a skilled technical assistance provider to guide them.

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?

The FDIC should seek to pool multiple bank resources together, and attempt to “mix and match” complementary portfolios. Combining better quality assets from multiple institutions could help bolster the pricing average for the overall portfolio.

The FDIC can also use its powers to marry smaller instutitions with larger ones in a combined portfolio sale so that both sellers can average up in the pricing.

The FDIC could use its powers to mandate and enforce the interplay of multiple lender pools and ensure equitable structures.

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?

    The conflicts to guard against include:

    1) private investors buying back loans upon which they (or afflilates) have previously have defaulted;
    2) having directly competitive assets;
    3) FDIC should be able to remove private investors for non-performance

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?

    The FDIC should delegate complete responsibility and authority to the private investor for the asset management (AM); AMs should have demonstrated experience, and be required to comply with standardized online reporting requirements mandated by the FDIC. Each venture should have quarterly reviews based on variance reports of performance and revised future business plans.

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?

    Value to servicing contracts should not be separately attributed.

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?

    Value is in the eyes of each investor; each investor will undertake their own underwriting and due diligence. Making available four month old (or older) appraisals done in an environment in which few transactions occurred benefits neither seller nor investor. Discount rates will continue to move in real time to reflect the increased risk premiums and return expectations. To be clear, recent appraisals that were done to meet FAS 157 mandates (now rescinded) serve little purpose and relevance to concluding a forward looking transaction.

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Comments on the LLP may be submitted until April 10, 2009.
You may submit comments by any of the following methods:

- E-mail: LLPComments@FDIC.gov. Include "Legacy Loans Program" in the subject line of the message.
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivery/Courier: Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m. (EDT).

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