To: Robert E. Feldman, Executive Secretary, FDIC

From: David Porter, President, The PNL Companies

Re: FDIC Request for Comment on the Legacy Loan Program (LLP)

Date: March 31, 2009

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

PNL has been active in acquiring special situation commercial loans since 1993 and was a highly successful partner with the RTC/FDIC in four public/private joint ventures in the 1990s totaling approximately $2 billion in book value. Prior to forming PNL, I was head of Real Estate Capital Markets at Goldman Sachs and head of Corporate Finance at what is now Jones Lang LaSalle. In that capacity, I was the lead financial advisor in structuring the National Land Fund, a $1.7 billion 50/50 public private joint venture for the RTC that helped lead to billions of dollars in subsequent joint venture structures. Given this past experience, I am a strong believer that the public/private model the LLP is undertaking is battle tested and can be designed to serve the public interest while liquefying the market and providing price discovery.

Below are PNL's responses to your questions:

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?*

   The focus, initially at least, should be on legacy real estate assets. This asset class has a well-developed history of public/private joint ventures and has a broad and established investor market. There may be certain types of real estate assets that are more problematic than others in the PPIF structure. Examples of such assets might include defaulted construction loans requiring substantial funding to complete the project and loans with no cash flow to support the underlying FDIC guaranteed debt.

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 FDIC should substantially restrict the ability of investors to pledge, sell or transfer their interests in the program. The joint venture programs initiated by the RTC in the 1990s, all required certain qualifications for the joint venture partners. These qualified parties should be restricted from selling their interests, unless there are compelling reasons, and then only to similarly qualified parties. Given the levels of leverage that may be applied to these portfolios, further pledging of the private sector partner's interest should be limited.

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 1993 National Land Fund had a fixed 50/50 structure, but some subsequent RTC joint ventures allowed a range of private-sector equity percentage bids. PNL was an investor in NP-1 and NP-2 in 1995. These programs allowed a range of between 30 and 50% of private-sector equity. PNL was a 30% investor in NP-1 and 50% investor in NP-2. The benefit of allowing a range of equity investment levels is that it potentially broadens your market of investors. The downside is that it dilutes the incentive of the private sector partner by diluting their required level of commitment. At high levels of underlying FDIC leverage, I would discourage structures that require less than 50% private-sector equity commitment. However, in scenarios where the FDIC leverage is well below 85% such reduced equity commitment levels may be acceptable. The critical factor is the absolute level of equity commitment that the private sector partner has. We would discourage structures with less than 5% private-sector equity as a per cent of total capitalization.

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

Given that the private sector partners will be stewards of public assets, we think it important that transparency in these transactions be required for all parties. One reason some parties may request anonymity is their fear of negative press or disgruntled borrowers. If they play by the rules there should be no issues. PNL worked out and collected thousands of accounts for the RTC and never had serious problems related to disgruntled borrowers or other parties.

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?*

Though it may require some additional work in closing large portfolio sales, a broad and diverse range of investment participation can only be attained if the levels of investment are within an achievable range of a broad number of entities. If individual pools are too large, then none but the largest investors will be able to participate. Encouraging a broad diverse range of investment anticipation also will maximize bid recovery. This is because the large bulk buyers will tend to discount the pools more heavily and bid on more of a price per pound basis. Smaller bidders will be focusing on individual assets and will bid those assets they are most knowledgeable about and best able to work out. This will not only improve bid pricing but will enhance ultimate recovery.

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?*

In answering this question, it is not clear what the average anticipated equity stake of a PPIF is. Clearly, each portfolio being offered should be broken down into individual pools. This will maximize total recovery and will likely best pair bidders with assets matching their capabilities and locale. In the National Land Fund we broke the $1.7 million portfolio into five regional pools. In most large loans sales, the pools are stratified by asset type, geography, size and/or borrower relationship.

Early auctions (1991-1992) by the RTC were frequently open outcry formats. My sense is that the RTC moved away from this format and towards less chaotic sealed bid auctions, because of the geographic diversity of the many bidders. A sealed bid format also protects anonymity during the bidding process. Since the last real estate recession, the rise of the internet has introduced some other bidding alternatives that perhaps combine the best of the sealed bid auction with the live auction. One format is an on-line auction where bidders can see other bids (though not necessarily the identity of the other bidders) and the bidding is real time. This saves the travel and staging cost of conventional live auctions and allows bidders to participate from their computers.

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

We've heard that the FDIC is considering focusing first on RMBS and then offering CMBS. This may be a good strategy given a greater level of distress in the residential sector at this time, and the more homogeneous nature of the RMBS assets. The commercial loans are going to be more heterogeneous and somewhat more complex to underwrite. For these reasons, we support the FDIC focusing on RMBS for the initial PPIF auctions

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

The two conflicting objectives in determining pool size are the greater simplicity of large pools and the likely negative impact such large pools would have on bid levels and ultimate recoveries in a joint venture format. Clearly, the FDIC is seeking to privatize large volumes of assets quickly. However, the additional administrative work of offering smaller pools should be more than offset by higher bid levels. Since the FDIC will be charging back the bidding and closing costs to the selling bank, this incremental cost should be covered by incremental increase in bid pricing at no cost to the FDIC.

We recommend that pools be generally in the $5-$50MM range. Clearly there may be some transactions targeted towards the very large bidders but overall the process will be enhanced if the smaller pool sizes are offered.

Constructing optimal pools seek to pair like assets to the degree possible. Characteristics to consider include class of asset, performing, versus nonperforming, location, etc. An example of poor pairing of assets would be a two asset pool with one asset being a stabilized industrial property and the other being vacant land. Mixing of these disparate assets in a pool forces either the conservative yield buyer or a more opportunistic land buyer to buy something they don't want and therefore to reduce what they will bid for the asset that best fits their portfolio.

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?*

The FDIC's offer to provide substantial leverage to these portfolio sales is perhaps the most important single aspect of the LLP. It is very important for the bidder to have a clear understanding of the FDIC leverage.

The first issue is the term of the debt being offered. We've heard that the FDIC is contemplating three-year debt. For many assets, this will be a reasonable but

there will be some other assets requiring longer-term financing than this. We recommend that the FDIC offer a three-year term with 25-50% of the initial facility extendable by an additional year or two with a possible extension fee or a 100 basis point increase in rate.

Rate is the second key issue. We recommend that the debt be fixed rate leased for the primary term. This will allow investors to more easily plan their underlying costs in this period of financial uncertainty. An alternative might be a fixed rate for certain number of years moving towards a floating rate in subsequent years. The rate or spread could increase after year 3. This would incent the private sector partners to replace the FDIC debt with private sector debt.

A third key issue is the release provisions associated with the FDIC debt. In a portfolio with numerous assets, the FDIC needs to be protected against releasing its security too easily. As a simple example, a portfolio might have five assets, each bid at $20 million. If the FDIC financing were for 85%, it would total $85 million. The first asset sold might be a home run and recover $50 million. The next two assets might recover $25 million each and the last two assets might be worthless. If the FDIC simply took its 85% of the original bid price at the sale of each of these assets, it would only recover 60% of its debt. For this reason, commercial lenders to distressed asset portfolios often have release provisions that require the release price for each asset to be the greater of 75% (should be higher if debt is higher than 75%) of net sales price or 110-125% of allocated loan amount. A formula such as this would protect the FDIC in the example above.

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?*

    It might make sense to have the selling bank take a note back from the PPIF. The selling bank clearly would be familiar with the assets and could likely provide the debt at a competitive rate with the FDIC guarantee. If the seller bank, or another private sector financial institution, is to act as the servicer of the FDIC guaranteed debt, it is important that the FDIC incorporate certain controls and protections into its guarantee. Private-sector servicers should be encouraged to apply all reasonable diligence to maximize recoveries and to properly service the loans. A fully guaranteed lender/servicer may not be incentivized to best protect the interests of the FDIC and the taxpayer.

    Public issuance of debt by the PPIF, or by the FDIC of pooled debt across several PPIFs, could be very cost effective at issuance and could have a secondary benefit of helping spur to the securitized debt machinery back into action. The problem with securitized debt is that the servicing process tends to be very cumbersome and unresponsive. The key here is how the servicing will be set up and what incentives are established for the servicer.

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?*

    Though one could argue that the level of the FDIC guarantee fee should be priced on the relative riskiness of the loans guaranteed, we would propose that the FDIC

have one guarantee fee but calibrate the relative riskiness of its portfolios by properly sizing the level of debt that it is willing to guarantee.

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?*

    If the portfolios are properly marketed to encourage sufficiently broad participation, then the proposed 50-50 pari passu structure for the Treasury and the private sector investor should not be modified or complicated by a back-end cap on the total profitability. Some portfolios will have outsized returns and other portfolios will be disappointing. Hopefully there will be more of the former than of the latter.

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?*

    There should be no problem with having multiple financial institutions include assets for individual sales events if each of the banks had separate pools for their assets. The problems of commingling loans from different financial institutions within a single portfolio can be resolved by requiring bidders to allocate their pricing in among the various assets. This requirement to allocate bid price by asset within pools should be required in any case to allow the FDIC to allocate is acquisition debt by asset in calculating release prices.

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?*

    Prior to bid, the conflicts potentially rising among LLP participants include the preference of large investors for large pool sizes and the preference for smaller bidders have pool sizes to accommodate the broader number of investors. Electronic war rooms, substantially reduce the potential conflicts of bidders that typically arose in physical war rooms. Prior to the creation of electronic war rooms in the late 1990s, it was often a bit of a fight among bidders to get access to the key documents and sometimes participants took or destroyed copies of documents key to competitors gaining an understanding of the transaction.

    Post-bid, the only major conflict we see is related loans being sold to different parties. The FDIC should be careful to sell loans that are cross collateralized or cross guaranteed to the same party whenever possible. In certain cases, a real estate developer investor might have guaranteed his or her loans to several different banking institutions. In this case, it is possible that buyers of these loans from the different banks may end up competing with each other to be the first to seek recovery under a guarantee. Though this situation does set up conflicts of interest, it is probably not worth the FDIC's time to monitor or control it since the underlying banks would have the same conflicts prior to the sale of their assets.

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?*

In the prior generation of RTC/FDIC public-private joint ventures, the qualifying private sector partner was assumed to have ultimate responsibility for the servicing of the assets in the joint venture. Indeed, the private sector team had to clearly demonstrate their qualifications as a condition of being selected. This is very important, because the quality and experience of the servicing is as important to the total success of the PPIF as which financial investor offers a few more marginal dollars in the bid.

PNL had the best ranking JDC JV and NP-2 JV because of superior asset management capability. Our pools often returned 50% more than competitors.

The government should have some qualifications process requiring the bidders to disclose their asset management team and experience. The FDIC should also be able to audit these PPIFs annually for financial and general compliance purposes.

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?*

    The PPIF should definitely get the master servicing rights to all the assets it purchases. Failure to get these master servicing rights means that the investor is not in control of the collection process once the loan becomes nonperforming. This substantially reduces bid value since the lack of control warrants a major discount. Normal servicing rights are not as critical but should be transferable at the discretion of the PPIF, whenever possible.

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?*

    Yes. The due diligence contractors and loan sale advisers create valuable information which can assist bidders in gaining confidence of their assumptions and in maximizing their bids. Property assessment reports, physical descriptions, rent rolls, lease abstracts, etc. should all be made available. Existing appraisals are also very valuable for the wealth of information they contain, in addition to their often questionable valuation summaries. The FDIC may want to redact its Estimated Recovery Values (ERVs) or the seller's reserve price but it is important to give the bidders as full an understanding of the assets as possible. The war room data should also include correspondence files and legal files since these documents give bidders a sense of the current status of the loan and the prior negotiations between the bank and the borrower.

<u>Questions for the FDIC</u>

There are a number of questions that have not been addressed in the press releases or website postings I have seen regarding the Legacy Loan Program. These questions are as follows:

1) Though there has been some discussion of the term of the FDIC debt, it is not clear what the anticipated term of these joint ventures will be. We suggest five years with two one year extensions subject to FDIC or Treasury approval.

2) I see no discussion of what the management fees for the management of the joint venture portfolios will be. In the case of the Legacy Securities Program, such a fee may not be necessary or significant. However, a management fee probably should

be included in the Legacy Loan Program. The National Land Fund had a 1% of bid value per annum non-accountable expense allowance to offset the general partner's internal costs. Third-party expenses, such as legal fees, consultants, travel costs, etc. would be born by the partnership.

3) Some thought should be given to how future capital calls will be handled. Most joint ventures allow for the general partner to call capital for what the RTC called Property Protection Expenses. These might include completing certain aspects of development, legal costs of protracted bankruptcies and buying out minority interests. The joint venture should contemplate whether the Treasury will fund on a pro rata basis for such expenses. It is possible that these expenses would be capped and any fundings in excess of the cap would be borne by the private sector partner with a preferred return associated for its excess fundings.

Conclusion

We hope the above response is helpful to your team in formulating the terms for the Legacy Loan Program. We are pleased to meet in person or speak over the telephone if you have further questions. We have copies of many of the old RTC public/private joint venture programs, which we are glad to share if they are not readily available to you. Additionally, we have loan facility documentation for distressed asset portfolios (Wells Fargo Foothill), which also might provide a good template for the FDIC's lending to the PPIF's.

PNL is interested to be an active participant in the Legacy Loan Program and wish your team every success in executing this program which, properly structured, clearly aligns public and private sector interests in maximizing recovery of these distressed assets.