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From Toxic Assets to Legacy Loans or How to Stop Worrying and Love the FDIC Program

[Harold P. Reichwald](#)

INTRODUCTION

Now that the fanfare is over, the hard analysis of the proposed plan (the "PPIP") to assist banks in divesting so-called legacy loans (formerly called "toxic loans") begins. Potential sellers and buyers have a lot to consider. Here are some issues to be further analyzed.

WHO IS A POTENTIAL SELLER?

The FDIC has it made clear that not every bank with legacy loans will be permitted to offer them for sale in the PPIP process. The FDIC, through the bank regulatory examination process, will identify those banks that are eligible and those deemed too far gone to be permitted to use the PPIP process. In a sense, it is likely to be the same process that was used by the regulatory agencies in recommending institutions for TARP funds. Those deemed to be ineligible will be encouraged to try to raise capital on their own, sell themselves or face liquidation in an FDIC receivership.

Institutional or portfolio size will not be an issue because the FDIC anticipates the creation of a pooling mechanism for those too small to offer legacy loans for sale on their own. Details on this aspect of the program are being developed.

WHO IS A LIKELY BUYER?

Since the FDIC strongly believes that the competitive market intended to be created by PPIP is in the best interest of all

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concerned, it is encouraging a variety of financial stakeholders to become participants, including pension funds, insurance companies, mutual funds and even individual investors.

Potential buyers will be pre-qualified in some fashion, perhaps not unlike the bidders for failing bank assets. As identified loan portfolios are aggregated for sale, a due diligence process will ensue leading to the receipt of sealed bids. Bidders will be bidding on the private equity piece of a to-be-formed pass-through entity tied to anticipated values of the offered legacy loans. The U.S. Treasury will contribute an equal amount, based on the current thinking of a 50-50 private-public ownership split, with the funds coming from the remaining original TARP Congressional authorization.

PRODUCTS TO BE OFFERED

The FDIC has made it very clear that it is targeting both residential and commercial loans, including construction loans. If the process being proposed proves successful, the FDIC is prepared to permit other categories of loans to be sold in the same manner.

PRICING MECHANISM

In recent months, portfolio sales have been relatively few in number, mostly because of the price disparity between the expectations of the seller and desire of the buyer to meet internal rates of return, after taking into account credit and market risk factors. Our experience in these transactions demonstrates that while this gap may be significant currently, the availability of leverage would greatly assist buyers in reaching their return hurdles. With this in mind, the FDIC will be providing a guarantee of privately made loans made to enable these purchases through the FDIC's Systemic Risk Authority. These loans plus the upside profit potential are intended to lure buyers to raise offering prices and eliminate the current price disparity. The maximum permitted leverage ratio will be 6:1 but will be separately set for each pool of identified loans in advance of the bidding based on credit characteristics and cash flows.

That said, the FDIC will be "consulting" with individual bank sellers to encourage them to accept offering prices that are lower than the book value of the assets in question. The FDIC expects that a bank which offloads its legacy loans through the PPIP process will present a much cleaner (and certainly smaller) balance sheet to the market, possibly, at least in some cases, enabling it to raise new capital to cover anticipated modest losses resulting from the

PPIP sale, if the assets are carefully selected. At the same time, the FDIC will hire independent valuation experts to help convince both sellers and buyer of the fair value of the legacy loans. The FDIC through its oversight of the process will be working hard to see that sellers and buyers come together on the determined price.

The FDIC expects to make money through guarantee fees and to eliminate risk through over collateralization based on inherent values in legacy loans being sold.

Sellers will have the opportunity to reject an offered bid and walk away from the process. However, having offered legacy loans for sale, the accounting question presented is whether these loans are now to be categorized as "held for sale," requiring mark-to-market accounting.

EXECUTIVE COMPENSATION RISKS

With the focus by Congress on limitations on executive compensation, it is natural for potential buyers to question whether their participation in PPIP will subject them to these restrictions. The FDIC has clearly said that the existing executive compensation rules will not apply to buyers. Sellers who received TARP funds will continue to be subject to those rules. Potential sellers who did not receive TARP funds probably will not be made subject to these or similar restrictions, but the FDIC left the door open to reconsider the matter during the comment period noted below.

TIMELINE

The FDIC has announced that the PPIP structure and rules of the game will be subject to a public comment period before being finalized. The Request for Comment announced on March 26, 2009 lists a series of 17 questions to which the FDIC seeks comment. The comment period expires on April 10, 2009. The questions range from issues such as the optimal asset categories and the structure of the PPIP funds which will purchase the assets to questions of public disclosure of the names of the investors in the funds and the permitted uses of the data used and conclusions reached by the independent valuation consultants. While the FDIC refuses to be pinned down on an exact time frame it seems likely that this PPIP will not become effective for several weeks after all comments are received, depending on the nature and extent of the comments. This should give plenty of time for potential sellers and buyer to assess the attractiveness of the PPIP process from

their own perspective. We are happy to assist in the submission of comments from interested parties.

Our work on behalf of both buyers and sellers of distressed asset portfolios, including buyers from FDIC, combined with our deep understanding and familiarity with banking and bank regulation, makes us ideally suited to assist sellers, buyers or servicers participating in the FDIC public-private program.

MANATT'S DISTRESSED ASSET GROUP

The FDIC's toxic asset program has generated substantial interest among prospective buyers and sellers of mortgage loan assets. Manatt's Distressed Asset group combines current market knowledge and long-standing experience as one of California's premier banking firms to help buyers and sellers navigate this complicated and evolving area. Since July 2008 we've closed five mortgage portfolio transactions on behalf of buyers and sellers, including transactions involving the FDIC. If you have questions or need assistance, we can help. For more information on Manatt's Distressed Asset practice, please click [here](#).

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FOR ADDITIONAL INFORMATION ON THIS ISSUE, CONTACT:



[Harold P. Reichwald](#) Mr. Reichwald is a highly experienced banking and finance attorney whose career encompasses domestic and international matters for banks and specialty finance institutions. His experience comprises a broad range of matters including: governance matters, sophisticated financial transactions such as asset securitization, LBOs, project finance, corporate lending and restructuring; representation of a variety of domestic and foreign financial institutions before the FDIC, Comptroller of the Currency, the Federal Reserve Board and other bank regulatory agencies in connection with new product development, chartering new banks and branches, issues arising out of the bank examination process and enforcement actions demanded by regulatory authorities. He was recently quoted on the PPIP in the [March 25 issue of BusinessWeek](#).

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