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PPIP Is Dead – Now What?

By Harold Reichwald, Barbara Polsky, and Clayton Gantz

FDIC Chair Shelia Bair seemed to sound the death knell for the PPIP Legacy Loans program when she indicated that some of parts of the program are still uncertain even as the FDIC was trying to put a pilot program in place to start shortly. The cause of the death of the Legacy Loans program was a toxic combination of policy and politics which caused major equity players to fear that the combination of government audit powers granted in recently-enacted legislation and the concern that the expected private profit-making would somehow be painted publicly as unconscionable after the fact.

Some observers have wryly noted that PPIP probably was only intended as a stalking horse anyway, just to freeze the marketplace while events unfolded to demonstrate in ways to bring some measure of confidence back to sellers and buyers. Whether that is a correct assessment of current conditions remains to be seen but banks still need to find ways to offload their Legacy Loans to private buyers.

The price disparity between sellers and buyers remains a difficult gap to bridge but it is worth pausing to explore possible alternatives to PPIP. It is likely to be the use of private market alternatives will provide the solution, albeit aided by a strong push from the FDIC to force banks to more accurately value Legacy Loans on their books. If such revised downward valuations result in bank failures, the FDIC seems quite prepared for that to occur. The recent spate of security offerings from the larger banks belies the difficulties that smaller banks are having

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in raising capital from traditional sources. So what are the possible resolutions that could be employed?

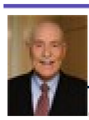
The key to this dilemma is to make the deployment of private equity into open banks an attractive alternative, freed from the traditional hostility that the bank regulatory agencies have brought to this possibility. Recent deals suggest that at least the OTS seems prepared to be more open to this, as evidenced by the BankUnited transaction.

More importantly, perhaps, is to revisit the "good bank/bad bank" structure that was employed at Crocker National Bank 25 years ago and which was refined in the Mellon Bank – Grant Street Bank a few years later. In both of these situations, and in others that followed, the key was fresh capital that permitted the troubled assets to be transferred off the bank's balance sheet at realistic valuations. In the Mellon case, the shares of the "bad bank" were spun off to Mellon's shareholders permitting them to participate in any upside profit potential from the nonperforming loans. Depending on the source of financing and other governance and structural matters, spinning off the shares or interests of a "bad bank" to the good bank's shareholders may allow the bad bank to remain part of the good bank "family" but not in a way that would force consolidation under accounting rules. Such a result also may permit the good bank to transfer the Legacy Loans at something other than a "fire sale" valuation. The "bad bank" is then left to manage those assets with skilled hands over time, measured in years not months, and ultimately to realize valuations on the disposition of the assets in the entire portfolio that bring returns that are in line with private equity expectations. The mix of debt and equity that could be brought to play in these situations are entirely dependent on each bank's circumstances but the key is skilled management and staff at the "bad bank." In some situations, an upside profit participation could be retained by the "good" bank.

Negotiated portfolio transactions with willing private buyers remains a strong alternative, as well, and may even hold out the possibility of some upside for the selling bank. Obviously, only the stronger institutions can afford to take a capital write down that might be required but this would be measured against the current drag on earnings caused by the troubled assets and the management time and expense devoted to them. A cleansed balance sheet with a strong bank management team and franchise inevitably will attract new capital from the market. As the outline of the PPIP program contemplated, available leverage would narrow the "bid/asked" spread. Creative structuring should contemplate a credible source of financing (by the seller or otherwise) for the portfolio buyers.

Unfortunately, this scenario suggests that banks who are in the "pray and delay" mode at the moment may not have much flexibility to do any private deals and will be left ultimately to be placed into FDIC receiverships and their loan assets auctioned through the current FDIC system.

The current situation behooves all those who would be players in the distressed asset market to begin to think creatively because notwithstanding the Government's apparent change of heart the opportunities are still there.



Harold 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. In addition, Mr. Reichwald has counseled senior executives, boards of directors, audit committees and credit review staffs of financial institutions, including conducting special investigations on their behalf. Mr. Reichwald's experience includes serving as Executive Vice President and General Counsel for Crocker National Corporation and its subsidiary, Crocker National Bank.

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