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FDIC Speaks of PPIP and Private Equity

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The FDIC took a considerable amount of criticism from the private equity community over its early July issuance of a Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions which imposed significant burdens on bidders for failed banks. Many saw this Statement with its high capital requirements and long investment holding period as an example of the FDIC turning its back on a substantial source of new capital for the banking industry at a time when new capital is so sorely needed.

However, the FDIC sought to reclaim the high ground with two pronouncements during the last week of July – one informal and one formal – which sought to attract not so much as new capital for the banking industry as to permit private equity to play a role in the failed bank process without having to acquire and run a failing bank. If this represents FDIC policy, it suggests that the regulatory agencies are not interested in saving failing institutions but rather in mitigating losses embedded in the financial system.

Informally Testing the Waters

Speaking at an industry conference, a senior FDIC official disclosed that the FDIC is looking for ways to split a failing institution into two separate pieces and ultimately offering each piece to a separate set of potential purchasers. Thus the franchise value of a failing institution – its deposits, branches, customer relationships and the like – would be offered to healthy banks while the troubled loan portfolio would be offered to other groups, such as private equity players, who have no interest in owning or running a bank but see the troubled loans as an opportunity to make handsome returns over the long haul. While there is said to be significant interest among knowledgeable players in the real estate marketplace for the troubled loans, the FDIC has not been able to generate significant bidding among healthy

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banks for the franchise value of the failing bank, apparently because those very troubled loans are seen as a drag on the whole bidding process. The details are said to be in the works and may involve new structures being put in place.

Beta Testing a Revised PPIP

The formal proposal is a reworking of the PPIP plan for troubled whole loans – the so-called "legacy loans" – being held by failing banks. This program is announced as approaching its test phase and unlike the original PPIP plan is directed only at the troubled loans of a failed institution. However, in concept it combines the leverage feature of the original PPIP with private equity.

The testing phase involves the pricing of a portfolio of residential loans offered on a servicing released basis to be transferred to a newly formed limited liability company, the equity in which will be split between the FDIC and the private accredited investor. If the private equity contributes all cash and does not use the FDIC leverage package, the equity split is 80% FDIC and 20% accredited private investor. With use of the leverage option, the split goes to 50-50.

The leverage option being offered is through an FDIC guaranteed note of the new LLC on either a 4-to-1 or a 6-to-1 basis, subject to established maximums. The higher leverage option carries with it certain performance tests which, if not met, require principal distributions otherwise payable to the private equity investor to be applied first to the repayment of the LLC guaranteed note. The lower leverage option has no such "first out" requirement. In return for the issuance of its guarantee, the FDIC gets a fee and a lien on the underlying collateral of residential loans owned by the LLC.

Since the testing phase will involve only troubled residential loans, the plan requires that the loan servicing conform to either the Home Affordable Modification Program or the FDIC's loan modification program.

The FDIC clearly believes that this structure may ultimately turn out to be the best way to remove legacy loans from bank balance sheets. However, the devil probably will be in the details of the LLC structure itself. For example, what does the term "accredited investor" mean in this context – the minimum standards currently in effect for bidding on failed bank assets through an online system? Or, is a higher standard contemplated? Also, the FDIC's announcement does not do anything to allay the concerns of the private equity community that the use of FDIC leverage will subject the equity investor to executive compensation limitations or to an audit by the Government.

OCC Provides Its Own Ideas

At about the same time, the Comptroller of the Currency released an interpretive letter which blessed a structure by which a national bank was permitted to create an LLC which would own, manage, market and sell OREO previously held by the bank. In return the bank was to receive an interest in the LLC while a property manager handles the details. Although the precise facts recited in the letter indicate that the genesis for the LLC was the fact that several banks originally were lenders to the real estate project in question and shared the LLC interests proportionately, nevertheless, the letter clearly lays out the permissibility of a national bank using the LLC structure to hold assets, probably along with a private equity partner in the LLC.

Conclusion

If these tests prove to be successful, the FDIC undoubtedly will seek to expand upon them and use these same approaches with commercial real estate loans and eventually commercial and industrial loans.

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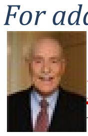

Harold P. Reichwald Mr. Reichwald is a highly experienced banking and finance attorney whose career encompasses domestic and international matters for banks and specialty finance institutions. His experience comprises a broad range of matters including: governance matters, sophisticated financial transactions 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.