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Investors Skeptical About Bank Asset Plan

Mandy Jackson, *The California Real Estate Journal, April 13, 2009*

As details were provided recently on the federal government's plans for pairing public funds with private capital to buy assets weighing down banks' balance sheets, investors came up with a whole new list of questions.

Answers are sure to emerge over the next few weeks and months as private entities respond to the terms laid out last month for the Public-Private Investment Program administered by the U.S. Department of the Treasury in concert with the Federal Deposit Insurance Corp. and the Federal Reserve.

Until then, investors are looking for more details on public-private investment fund structures and terms that were not clear in the plan outline unveiled by U.S. Treasury Secretary Timothy Geithner on March 23.

Through the program, the Treasury Department hopes to leverage public dollars with private equity to buy $500 billion to $1 trillion worth of "legacy assets" - commercial and residential loans and mortgage-backed securities issued before 2009 - off of banks' balance sheets to free up capital for new lending.

Richard Hollowell, managing director in Los Angeles at Alvarez & Marsal Real Estate Advisory Services LLC, said it looks like PPIP will help boost liquidity at U.S. banks.

"I'm optimistic that it will allow some of the assets to be moved," Hollowell said. "Whether it affects the availability of credit at some point remains to be seen. The legacy or toxic assets are really only part of the problem with the credit markets."

PPIP is one of several initiatives in the Financial Stability Plan announced by Geithner on Feb. 10. Other programs include stress tests for large banks requesting more money from the Emergency Economic Stabilization Act of 2008 and its Troubled Asset Relief Program, a consumer and business lending initiative of up to $1 trillion, housing support and foreclosure prevention, and funds for small business and community lending.

Under the program's Legacy Loans Program, private investors pre-approved by the FDIC will bid on pools of loans. The Treasury and the investors will put in equal amounts of equity and the FDIC will guarantee debt backing the purchases.

Investors are expected to include individuals, financial institutions, insurance companies, mutual funds, publicly managed investment funds and pension funds.

Under the Legacy Securities Program, financing from the Federal Reserve and the Treasury and eventually through the Term Asset-Backed Securities Loan Facility, TALF, will be offered to at least five fund managers selected to buy securities with their own private capital and an equal equity contribution from the Treasury.

The Treasury and FDIC extended the deadline for applications from April 10 to April 24 and will take until May 15, instead of May 1, to select fund managers with the capacity to raise $500 billion in equity and that already have $10 billion in mortgage-backed securities under contract.

After the initial five fund managers are selected, the Treasury Department will consider the selection of additional applicants to keep the program open to as many large and small private investors as possible.

Program Incentives

While the Treasury and Federal Reserve will provide 50 percent of the equity in each PPIP transaction and the FDIC will guarantee debt for the purchases, the private investors and fund managers will determine the appropriate pricing for loan pools and securities and retain control of asset management with rigorous oversight from the FDIC.

Harold Reichwald, partner in Los Angeles at Manatt, Phelps & Phillips LLP and co-chair of the law firm's banking and specialty finance practice group, said there has been some discussion that banks might be able to share in the upside of the loans and securities they sell through PPIP.

"That's significant because it gives the banks some incentive to sell for a lower price today on the expectation that they could make more later," Reichwald said.

That issue and others will be defined more clearly this month after the FDIC responds to the comments it asked investors to provide after details of the PPIP were announced.

"This is filled with various incentives to bring seller and buyer closer together on price," Reichwald said. "The experience we've had on trying to do these deals privately is the parties can't get to the price point where sellers protect themselves from erosion of capital and buyers can hit their returns."

He does not anticipate that private investors will be scared off by FDIC oversight that is designed to make PPIP an open and honest process, but he noted that the government will have to be sensitive to how private equity works, because investors will not want to have a

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federal agency looking over their shoulders.

"They won't want the FDIC to have oversight over how to work out or modify loans," Reichwald said. "Frankly, the FDIC would be foolish to interfere in that. There will most likely be some overall parameters, but that's no different than when you have a passive investor."

D. Eric Remensperger, partner in the Los Angeles office of law firm Proskauer Rose LLP, said PPIP may not be enough to close the gap between buyers' bids and sellers' asking prices for loan portfolios and securities unless banks have already significantly written down the assets' values on their balance sheets, because investors will price the challenge of partnering with the government into their bids for loans and securities.

"The investor wants to be in the driver seat," Remensperger said.

He said limits on executive compensation could also curb investors' appetites if such rules are enforced for PPIP participants. Congressional action to reclaim 90 percent of $165 million in bonuses paid to executives at bailed-out insurance company American International Group could give investors second thoughts.

"What Congress has done has given a lot of investors pause about doing business with the federal government," Remensperger said. "The [PPIP] term sheet says 'passive' investors aren't subject to compensation rules. But if you're a fund manager, you're an active investor. That's an issue that's going to have to be addressed before these investors step in."

If the FDIC or the Treasury were to make private investors in PPIP subject to executive compensation guidelines, that would be the death knell for the program, Reichwald said.

However, it does not appear from the terms released so far by the Treasury and public comments made by federal officials that PPIP investors will be subject to the limits on executive compensation that companies receiving TARP funds must comply with.

Regulatory Concerns

Reichwald said he does not expect recent regulatory proposals for non-bank financial institutions to have an impact on the hedge funds and private equity groups that might participate in PPIP.

Geithner proposed legislation on March 25 that would create a resolution authority to take over financial institutions that are not covered by the FDIC but pose significant risk to the financial system if they are allowed to fail, such as AIG and the now-bankrupt investment bank Lehman Brothers.

Geithner also outlined a new framework for regulatory reform on March 26 that addresses risks posed to the financial system by the failure of non-bank entities; proposes regulations for groups such as private equity and hedge funds; eliminates gaps in the federal regulatory structure; and fosters international coordination.

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Commercial real estate professionals including (from left to right) Bill Ballard of Grubb & Ellis | BRE Commercial in San Diego and Mitch Siegler, Lorne Polger and Scot Eisendrath of Pathfinder Partners LLC still have many questions about the federal government's Public-Private Investment Program for buying legacy assets from banks.

The Financial Accounting Standards Board has been discussing changes to fair-value accounting rules, also known as mark-to-market, which would allow banks to use their own judgment in marking assets to fair market values, including mortgage-backed securities. This could reduce the negative impact of real estate value declines on banks' balance sheets.

Reichwald said he doesn't think that relaxed mark-to-market requirements will be a disincentive to banks selling legacy assets. If they were already planning to sell loans and securities to private investors, he said they will continue to do that to raise capital.

Reichwald also said the mark-to-market rule change shouldn't raise values to a level where investors won't want to buy loans and securities.

Hollowell said a lot of lenders have been waiting for the PPIP guidelines and the changes to market-to-market to be announced before determining whether they want to sell assets.

"Certainly any change in mark-to-market would beg the institution to revisit whether or not it sells those legacy assets or whether it holds those assets for a better day," he said.

Hollowell noted that the PPIP terms released last month do not discuss what will happen if banks reject the offers for their loans and securities when bids come in lower than the reduced values that lenders have already assigned to them.

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"To me, [PPIP] is the start of mark-to-market," Hollowell said. "It took the [Resolution Trust Corp.] six years to mark everything to market. The first assets were taken over in 1986 and they didn't mark the last asset to market until 1992."

Once all of the assets taken over by the federal government's RTC in the late 1980s and early '90s had new values assigned to them, the economy began to improve, credit became more available and the markets began to get back in order.

Hollowell noted, however, that the PPIP and other government programs to repair the economy will probably deal with 10 to 20 times more troubled assets than were handled by the RTC.

Skeptical Investors

While there may be unprecedented opportunity to buy real estate loans and securities, investors are still reticent to move forward in partnership with the government until more details about PPIP are available and even until some of the first transactions close under the program.

Domenic Drago, a partner in the Del Mar Heights office of law firm Sheppard Mullin Richter & Hampton LLP, said investors are skeptical about the quality of the loans that lenders are likely to sell through this process on top of their concerns about Treasury and FDIC oversight.

"While they say the private investors will control the assets with FDIC oversight, most real estate investors are not used to Big Brother looking over their shoulder," Drago said. "But others do have experience in public-private investment."

Investors are intrigued by the high level of loan guarantees that are being made available, but Drago said many will wait for the first round of loan sales to be completed under PPIP before they get involved in the program.

The Treasury Department provided examples of how the Legacy Loans and Legacy Securities programs might work.

A bank might agree to sell a pool of loans with a face value of $100, which investors would bid on at auction. A winning bid of $84 would be eligible for financing guaranteed by the FDIC at a 6-to-1 debt-to-equity ratio. The Treasury and the investor would evenly split the $12 equity requirement and the investor would get an FDIC-backed loan of $72.

In terms of the securities program, if a fund manager raises $100 in private capital, the Treasury would match that with its own $100 in equity and provide up to $100 in debt financing. An additional loan of up to $100 would also be considered. The fund manager would then have $300 to $400 in total capital to buy securities. TALF funds might also be accessed.

Lorne Polger, managing director of Pathfinder Partners LLC, a San Diego-based firm that makes opportunistic investments in distressed multifamily real estate and defaulted loans, said there are investors without the PPIP program who want to buy loans and securities from banks, but the assets aren't trading because buyers and sellers can't agree on prices.

"Buyers are at much lower prices because the buyers have a much higher yield expectation for a variety of macroeconomic reasons," Polger said. "The goal of the [PPIP] program is to artificially inflate pricing through the use of leverage to allow this stuff to trade."

Bill Ballard, who works in the Financial Advisory Services group at Grubb & Ellis | BRE Commercial, said there might be a 20 percent spread between buyers' bids and sellers' asking prices and if the buyer has access to debt it can pay a little bit more for the assets.

While investors can make a lot of money because they are putting so little of their own equity in the game, Ballard said they are also taking the risk that if the economy doesn't improve they will be looking to unload the same assets at a discount in a few years.

Mitch Siegler, senior managing director of Pathfinder Partners, said the mortgage-backed securities can be traded much more easily than pools of loans.

"Whole loans on completed, fully leased projects are tradeable but not as much as the securities, because you might end up with the property and have to operate it," Siegler said. "Then there's partially completed projects that may need more money invested."

He said it makes sense to have five fund managers with at least $500 million in equity involved in the Legacy Securities Program, because they will have the capacity to buy securities and move them off banks' balance sheets quickly.

Siegler predicted that it will be more difficult to sell a construction loan for an incomplete condominium project to a smaller investor in a short timeframe at banks' current prices because of the higher level of risk involved.

Even Polger and Siegler, partners in the same firm, can't agree on the quality of loans that might be sold under PPIP. Polger said banks can already sell higher-quality assets, so they are more likely to offer lower-quality assets under the government program. Siegler said the loans sold through PPIP might also include higher-quality assets on which banks have not been able to agree with sellers on price.

Ballard said PPIP will create more interest in buying loans and securities, but the program still depends on what private investors are willing to pay and whether or not the banks will accept what the market says their assets are worth.

"It comes down to whether the loans sell at the prices they need to sell at and then how many banks can withstand the stress test after that," he said.