

Legacy Loan Program — Mind The Gap

Despite delays in the roll out of the Legacy Loans Program (LLP) component of the Public Private Investment Program (PPIP), the FDIC has reiterated that it intends to follow through with the development of the program. The Legacy Loans Program represents an effort to help banks cleanse their balance sheets through the disposal of nonperforming loans at better-than-current-market prices. While we believe the LLP could help narrow the gap between buyers (investors) and sellers (lenders) of distressed assets, we believe a gap will remain, based on some sample calculations we have performed for “before” and “after” scenarios.

We have compared bid prices for PPIP and non-PPIP buyers in two scenarios, with alternative assumptions about debt levels (for the non-PPIP buyer) and holding periods. We examined the following:

- Deeper initial discount, higher expected returns (80% discount to face value, 35% target IRR) vs. lower initial discount, lower expected returns (70% discount, 25% IRR);¹
- Original — or non-PPIP — buyer utilizing no debt or 50% debt;
- Holding periods of 3, 4 and 5 years.

The main ingredient in the Legacy Loan Program is the availability of high leverage at low cost through the FDIC. The FDIC will provide guarantees on debt raised by the funds. By allowing investors to lever up to 85% of the investment, investors could afford to pay more for distressed assets (loans and securities) than in an unlevered or lower-levered situation, and still hit high returns.

- While the greatest price gains (PPIP- vs. non-PPIP) will come in the scenarios where investors are targeting the highest returns, these are also likely to be the situations where investors are making especially low bids vs. face value, so the likelihood of a remaining bid-ask spread is high.
- For longer anticipated holding periods, the PPIP-buyer can afford to pay more than for shorter holding periods. Our analysis probably overstates this impact (see for example the discussion of deeper discounting for longer holding periods in the “Calculation Details” below), but there is likely a positive impact on longer-term holding periods created by the high leverage at low cost.

¹ These discounts are supported by our analysis of FDIC sales of non-performing loans during 2008 and early 2009, which were sold at an average 73% discount to book value.

Comparison of Distressed Loan Prices* PPIP vs. Non-PPIP Buyer

Holding Period (Years)	Original Bid	PPIP Buyer	Increase
1) 80% Discount, 35% IRR			
a) No Debt in Original Bid			
3	20	38	90%
4	20	45	125%
5	20	52	162%
b) 50% Debt in Original Bid			
3	20	29	45%
4	20	32	62%
5	20	36	81%
2) 70% Discount, 25% IRR			
a) No Debt in Original Bid			
3	30	48	60%
4	30	55	84%
5	30	62	108%
b) 50% Debt in Original Bid			
3	30	40	32%
4	30	43	45%
5	30	47	57%

* Prices are shown in terms of a discount from 100% face value.

Source: Foresight Analytics

- The best prospects for closing the bid-ask gap are probably in situations where investors have lower return targets and would be seeking less of a discount. For example, the highest PPIP bid prices are in scenario 2a) from the accompanying table.

We think the LLP will require a mechanism to help close the remaining gap indicated by our calculations. One idea is a participation note that allows the holder (e.g., the government or seller) to participate in the potential upside. So, for example, if returns on the investment exceed a certain hurdle rate, the participation note holder would be entitled to a share of the excess gains. A similar result might be obtained through the issuance of options with staggered strike prices and expiration dates. In any case, we believe the need for additional help in closing the bid-ask gap is real, and will be a necessary component in making the program work.

Calculation Details

Our calculations represent simplifications of the actual factors underlying asset pricing and investment return calculations, but we believe they at least give a broad sense of the dynamics at work.

Assumptions for the PPIP Buyer:

- 85% leverage (through FDIC guarantee)
- 2.5% interest rate (Note - we have heard lower rates cited, in the neighborhood of 1.5%, but we believe the effective rate will be higher than that, as the FDIC will be collecting a fee for providing the guarantee; furthermore, interest rates have risen since our calculations were performed).
- We have assumed no income from the loans (assets) during the holding period, i.e., all the value realized comes at a end of period "sale." This simplifies our calculations, and also probably approximates the situation with a significant portion of nonperforming loans, such as defaulted loans lacking any sort of payments.

A note of caution: we are starting with the bid prices and calculating ending values using target IRRs. In reality, it is more likely that investors will estimate the ending value first, then back into a bid price using their target IRR and an anticipated holding period. Our method "rewards" longer holding periods by estimating higher ending values, whereas the likely true investor approach would result in deeper discounts to the bid prices for longer holding periods.

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