FDIC Tests Funding Mechanisms Under Legacy Loans Program

The Federal Deposit Insurance Corporation (FDIC) has started to sell assets out of receivership to test funding mechanisms that may be used in future sales of troubled assets under the Legacy Loans Program (LLP) that was first announced in July. The LLP is part of the Public-Private Investment Program of the United States Department of the Treasury, in conjunction with the FDIC and the Federal Reserve. The program was announced last March and is designed to help banks remove troubled loans from their balance sheets. Billions of assets will eventually be on the block and the structure of the first two deals provide good information about the kind of vehicles the FDIC wants to use to shed assets. With the difficult experience of participating investors interested in distressed or failed bank deals, this may be a more welcome place for capital available from investors.

FRANKLIN/RCS DEAL

The first of these sales was announced on September 16, when the FDIC announced Residential Credit Solutions (RCS) as the winning bidder in a pilot sale of assets from Franklin Bank SSB (Franklin), in receivership since November 2008. RCS is a residential mortgage investment and servicing company focused on credit-sensitive and servicing-intensive assets formed in 2007 by private equity firm Equifin Capital Partners, together with Och-Ziff Capital Management Group and other institutional investors. The transaction has not closed as yet. According to information made available by the FDIC, the FDIC will establish a limited liability company (LLC) to which it will transfer a portfolio of Franklin residential loans with book value of $1.3 billion. The equity interest in the LLC will be held 50/50 by the FDIC and RCS, which will pay $64,125,000 for it in cash. In addition, the LLC will issue to the FDIC, as receiver, a $727,770,000 amortizing note. The note will have a 4.25 percent coupon payment funded by cash flow from the mortgages and will be guaranteed by the FDIC in its corporate capacity. The FDIC anticipates selling the note at a future date.

The bid confirmation letter with RCS followed a competitive bidding process. The FDIC solicited 719 parties to look at the portfolio and received 19 separate bids. Bidders could choose between a 4-to-1 or 6-to-1 leverage, or submit a cash bid for 20 percent of ownership interest. The RCS winning bid uses a 6-to-1 leverage. At its July announcement, the FDIC indicated that bids incorporating the 6-to-1 leverage alternative would be subject to performance thresholds, including delinquency status, loss severities, and principal repayments. If any of the performance thresholds are triggered, amounts that could otherwise be distributed to the equity investors should be applied toward the reduction of the note.

The present value of the RCS winning bid equals 70.63 percent of the outstanding principal balance of the portfolio being transferred, based on FDIC's analysis and assumptions. Reports indicate that without such funding mechanism investors would be willing to pay 50 cents on the dollar for such portfolio. FDIC said RCS's offer was chosen because it "would result in the greatest return for the receivership of all competing bids." RCS's participation in the Home Affordable Modification Program might also have counted on its favor.

CORUS/STARWOOD DEAL

On October 6, 2009, the FDIC announced that it had signed a bid confirmation with a consortium managed by Starwood Capital Group, which also includes TPG Capital, Perry Capital and WLR LeFrak (Starwood Consortium). The Starwood Consortium will hold 40 percent of the equity of Northwest Investments LLC, formed to acquire performing and non-performing construction loans and real estate owned (REO) assets of Corus Bank, N.A., in receivership since September 2009, with an unpaid principal balance of approximately $4.5 billion. The transaction was expected to close in October, but the closing has not occurred to date. The Starwood Consortium will pay $554.4 million for the 40 percent equity interest in the LLC. The FDIC will hold the remaining 60 percent interest. The Starwood winning bid uses a 1-to-1 leverage and the structure contemplates an equity kicker that would raise FDIC's interest to 70 percent once the investors have received cash distributions equal to (a) 2x initial investment and (b) a 25 percent IRR. The note to be issued to the FDIC, as receiver, will have a face value of $1.386 billion, bullet maturity, a zero coupon structure. It will be guaranteed by the FDIC in its corporate capacity and must be repaid before any distribution may be made to the investors. The FDIC anticipates selling this note into the market. The winning bid has a value of $2.77 billion, or approximately 60 percent of the assets being transferred.

In addition, the FDIC, as receiver, will provide an advance facility to the LLC of up to $1 billion over the next five years to fund construction of incomplete buildings, operating deficits in completed buildings, and other asset-related working capital needs. The facility will bear interest at a rate equal to LIBOR + 300 bps and must be repaid before any distribution may be made to investors. The FDIC will be able to syndicate up to 51 percent of the facility without the LLC's consent.

If you would like to discuss the Legacy Loans Program further, please feel free to contact your regular Ropes & Gray attorney.