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PIPP, PIPP, Hooray!

Today, at the behest of industry and a certain Congressional elements, the Financial Accounting Standards Board (FASB) is set to vote on the loosening of the so-called mark-to-market rules affecting banking institutions. This expected action has set off a global rally in the equity markets based on the specious notion the less transparency is a good thing for investors in bank shares. In this report, we go beyond the issue of the unfortunate mark-to-market debate to demonstrate that it is the least of the major problems impacting U.S. banks and to support the need for the Public Private Investment Program.

Highlights

- While perhaps in the minority, we applaud the joint efforts of the U.S. Department of the Treasury (UST), the Federal Deposit Insurance Corporation (FDIC) and Federal Reserve Bank (FRB) in developing the Public-Private Investment Program (PPIP), released for public comment last week.

- Many of the PPIP's opponents favor full or partial nationalization of severely troubled banks and FDIC seizure of failing banks as an appropriate way forward, from the U.S. taxpayer's standpoint. But we see the PPIP as, at worst, a buffer against the fire-sale prices at which toxic bank assets would almost assuredly be sold after such large-scale nationalization or seizure (and the resultant losses to taxpayer) and, at best, a way to reduce the number of such seizures.

- While changes to the mark-to-market rules for securities are ill-advised, the fact remains that most of the vulnerable debt holdings by commercial and savings banks are held in the form of whole loans, not securities, and whole loans booked as "held-for-investment" (the vast majority) are not subject to marks. Banks have nearly $4.7 trillion of whole loans, compared to $2.7 trillion of vulnerable securities.

- Loans held-for-investment needn't be written down until they go bad, but have already seen a near 30% collapse in the value of residential real estate and a substantial decline in commercial real estate values is well underway. Every day, more loans are becoming delinquent and defaulting—and are hitting banks' equity capital. Those supportive of steady-as-she-goes options for the banking system are ignoring the massive yoke that successively-defaulting, underwater loans place on our financial system.

- We believe the PPIP is a necessary part of what should be a two-part plan to re-regulate and revive our presently moribund banking sector. We see no better way of preventing troubled assets from continuing to weigh down the ability of U.S. banks to function normally—other than to remove them or segregate them. The segregation route—essentially having the government act as aggregator into a "bad bank"—has been justifiably rejected because of concerns over establishing transfer pricing.

- But the LLP component of the PPIP will not be effective unless the FDIC couples it with an aggressive, though fairly and evenly applied, effort to push the banks they regulate to divest of their problem loans. In this report, we provide our suggestions on how such an effort might be executed.

Overview

While perhaps in the minority, we applaud the joint efforts of the U.S. Department of the Treasury (UST), the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Bank (FRB) in developing the Public-Private Investment Program (PPIP), released for public comment last week.

The PPIP (and *we* leave the first "P" silent, as we view the Beltway acronym "Pee-PIP" as overly editorial) has already attracted its share of doubters and cynics who have declared it dead on arrival, too complicated, TARP II (Paulson 2.0), or simply impossible to execute in an effective manner. We'd like to be a little more constructive.

The PPIP is hardly perfect and presents a number of unresolved issues that will need to be addressed. In fact, any thoughtful observer who reads the FDIC's solicitation for public comment on the PPIP's Legacy Loans Program (LLP) component must recognize the PPIP as a work in progress promulgated by well-intentioned and focused policymakers who clearly understand the economic and political obstacles to be overcome. Yet, in the PPIP's organization, it's clear that (i) banks cannot continue to fulfill their mission of capital formation and allocation while burdened with unprecedented amounts of nonperforming and/or seriously troubled assets, and (ii) the write-downs and reserves banks have taken to date have impacted their securities portfolios and nonsecurities portfolios in very different ways.

As a result, the PPIP includes different "silos" or programs targeting real estate-backed securitized debt, on the one hand, and "whole loans" (un-securitized, old-fashioned bank loans and their participations), on the other. The UST/FRB white paper (and other documents) describing the PPIP in detail can be found at www.treasury.gov/press/releases/reports/ppip_whitepaper_032309.pdf. We will not go into detail here about all of the program's features in this piece; this report specifically examines the problems that led to the PPIP's genesis and the potential problems endemic in its execution.

The PPIP, at least initially, will target the continuing crisis affecting the largest component of the U.S. debt capital markets—and the largest component of bank assets, mortgage debt (both residential and commercial). The FDIC has said it will consider expanding the LLP to include other assets (unsecured and consumer loans, for example), but the Legacy Securities Program (LSP) is, at least for now, restricted to moving off bank balance sheets securitized residential and commercial mortgage-backed bonds that, prior to the crisis, were rated AAA. The LSP is fairly straightforward, whatever one may think of the program's efficacy. But effective implementation of the LLP will take additional massaging and all the regulatory and political finesse the FDIC can muster.

Before we jump ahead, we need to review some of the arguments advanced by the PPIP's opponents, who favor full or partial nationalization of severely troubled banks and FDIC seizure of failing banks as an appropriate way forward, from the U.S. taxpayer's standpoint. We sympathize enormously with the views of the Krugman, Roubini and Steiglitz crowd (and have enduring respect for their work and courage during this crisis) and agree completely that there is no rationale for stakeholders, in banks being bailed out by the government, to share materially in any recovery thereof. But we're curious about what the PPIP's opponents think will happen to the bad assets after the banks are nationalized or seized. The answer? Bad assets would be auctioned to private buyers at fire-sale prices, as happened during the days of the Resolution Trust Corporation (RTC). The losses on those assets, after wiping out existing stakeholders, are assumed by the government because the FDIC essentially insures all bank deposits.

During the RTC days, however, we still had active capital markets (and the crisis of the ’90s was mostly concentrated in commercial real estate—not all real estate and other assets, as it is now). Traditional commercial real estate lenders had fled the market, of course, but the birth of a fledgling capital market for a then-exotic product called “Commercial Mortgage Backed Securities” was ready to take up the slack (we recall, with a bit of wistfulness, the very first CMBS mortgage pool transaction, way back in 1990). In the present crisis, we have no risk-oriented lenders willing to step in and a capital market seized by severe dislocation.

The PPIP represents a shot at liquidating bad assets without holding a fire sale. The inclusion of government-provided leverage (albeit hopefully at lower debt ratios than the program’s 6:1 maximum onto which critics have latched) is a proactive move to limit the losses that are to come—not to exacerbate them.

Why Is the PPIP Necessary?

Let’s recap the mortgage and debt crisis in light of the PPIP’s structure. The reason so much attention is being paid to troubled real estate loans and securities is best illustrated by the table below:

Figure 1 - Anatomy of a Debt Bubble	2000	2007	Increase in Debt	% Increase	Annual % Increase Adj. for Inflation	Annual % Increase from 1952-1999 (Adj)
Total U.S. Mortgage Debt						
1 to 4 Famiily Residential	5,126,531,000,000	11,136,000,000,000	6,009,469,000,000	117.22%	8.79%	5.57%
Commercial and Multifamily	1,575,146,000,000	3,265,000,000,000	1,689,854,000,000	107.28%	8.25%	4.75%
Farm	84,724,000,000	117,000,000,000	32,276,000,000	38.10%	2.04%	1.39%
Total	6,786,401,000,000	14,518,000,000,000	7,731,599,000,000	113.93%	8.60%	5.20%

Source: Federal Reserve Statistical Release, Z.1, Flow of Funds Accounts of the United States, March 6, 2008

As alarming as the foregoing numbers are, what’s more troubling is that nearly all of the financial institutions driving debt creation didn’t see, or ignored, the fact that the massive bubble in values of debt collateral (the homes and commercial buildings against which the loans were made) was almost entirely driven by the availability of the debt itself. There was no comparable increase in rents, productivity, inflation, or the size of the economy that came anywhere near justifying the ballooning of asset values—and when the ability to create additional indebtedness hit the wall, the balloon popped and asset values no longer support the loans that are still outstanding against the underlying real estate.

With the collapse of the asset bubble leaving lenders and mortgage-backed securities holders impaired (underwater) and exposed to large-scale loan losses,[1] the fundamental questions from the PPIP’s and banking system’s points of view are: Just how much of these losses are likely to impact U.S. banks? How have the banks recognized them to date? In what form is the exposure held?

To shed some light on this issue, we delved into the forms in which real estate debt is held by U.S. commercial and savings banks, illustrating our findings on the following table:

[1] In our report last week, we reiterated our previous forecasts of loan losses for all real estate-related bubble-era debt, and derivatives thereof, at between $2.1 and $2.4 trillion.

Figure 2 - Exactly Where are the Problems?

	Total	Residential	Multifamily and Commercial
Total Non-farm Outstanding Mortgage Debt in U.S.	14,614,100,000,000	11,164,450,000,000	3,449,650,000,000
Holders (approx):			
Commercial and Savings Banks in whole loan form	**4,656,001,000,000**	**2,971,783,000,000**	**1,684,218,000,000**
Mortgage Backed Securities			
Government Agency Guranteed	4,890,199,000,000	4,741,674,000,000	148,525,000,000
Private Issuers (non-guaranteed)	**2,686,576,000,000**	**1,928,777,000,000**	**757,799,000,000**
Government Agencies (GSEs)	614,773,000,000	368,859,000,000	245,914,000,000
Life Insurance Companies	330,100,000,000	11,819,000,000	318,281,000,000
Individuals and Other (1)	1,347,422,000,000	1,052,533,000,000	294,889,000,000

(1) Includes mortgage companies, real estate investment trusts, state and local credit agencies, state and local retirement funds, noninsured pension funds, credit unions, and finance companies.

Source: Federal Reserve Board—Statistical Supplement, December 2008

The upshot of Figure 2 is that most of the vulnerable debt holdings by commercial and savings banks are held in the form of whole loans, not securities. Here's why: While it is true that mortgage backed securities (MBS) outstanding aggregate $7.6 trillion, or more than half of total mortgage debt outstanding, 65% of this amount is government guaranteed in one form or another. Government-guaranteed MBS experiences minor fluctuation in value relative to prevailing interest rates, but its credit (at least we hope) is not a factor in valuation. This is not a great thing for the U.S. taxpayer, who will pick up all of the burden from defaults on mortgage loans underlying guaranteed MBS (and there will be some losses), but it is also true that the mortgages insured or held by government agencies are of generally better credit quality than those in private MBS or on banks' books. For now, this offers limited comfort, as the government will also be exposed to a good chunk of the losses that will ultimately leave some banks insolvent.

So, to accurately assess the situation in which U.S. banks find themselves, one needs to look at the comparison of the two principal sources of ongoing losses: primary MBS and derivatives thereof that banks hold as "available for sale" (AFS) and loans held by banks on balance sheet as "held to maturity," often called "whole loans" to distinguish those that are sliced up in securitizations.[2] As Figure 2 demonstrates, whole loans on the books of commercial and savings banks are far larger, at $4.7 trillion, than the entire amount of credit-exposed, non-government-guaranteed, private MBS outstanding on all U.S. real estate of $2.7 trillion. And, of course, a sizable chunk of this $2.7 trillion is held by not-so-lucky investors outside of the domestic banking system. In fact, it should be kept in mind by anyone interested in—or commenting on—the PPIP, or any element of the debt mortgage and crisis, that approximately 80% of banks' assets in the United States are held as whole loans.

[2] Larger (generally multifamily and commercial) whole loans are, however, often divided among banks as "participations" in loan syndicates—with multiple banks kicking in to carry a given credit exposure.

The Mark-to-Market Misconception

Why is the above so important? Because whole loans are almost always regarded as being held to maturity and consequently are not exposed to the mark-to-market (MTM) rules that we have heard so many in industry and government calling into question as a possible culprit for the condition in which financial institutions find themselves. Yes, that's right. All that noise about MTM really has nothing to do with the majority of the potentially troubled assets on bank balance sheets.

Sure, the garbage CDOs and CDSs derived from impaired MBS held by banks have been drastically written down (although, as we saw with Merrill last year, perhaps not all the way to what would clear the market even with the enhancements offered by the PPIP). Yes, some tranches of residential, and to a far lesser extent, commercial MBS has been marked to lower values reflective of the lower collateralization and, for commercial properties, debt service coverage ratios on the underlying mortgages—and to reflect skyrocketing default and delinquency rates on many types of residential mortgages. Yes, there is a reasonable argument that we—and the regulators—don't really know if those marks are adequate relative to what can reasonably be ultimately collected, over any time frame, on even the more senior securities.

We have written at length about the difficulties faced by regulators, and the economy in general, in the process of rescuing the banking system. Much has been said by others on the subject of MTM accounting—pro and con—while we (generally supportive of MTM rules) have been relatively mum on the matter. Why? Because MTM is not applicable to the largest contingent of mortgage exposure held by banks—whole mortgage loans—which are often not written down or reserved against until they have gone into actual default.

We are not saying that the MTM issue doesn't matter and the marking to market of securities held for sale or trading is a significant problem for our regulated financial institutions; obviously, the collateral ultimately securing such obligations has fallen dramatically in value and in ability to generate cash flow, so the likelihood of full repayment of such securities has been substantially diminished. We are further influenced in our conclusion by comments and observations from traders and valuation experts that continue to illustrate very wide "bid/ask" spreads for all but the most unassailable structured private debt securities—and the continuing impossibility of bringing together buyer and seller on the issue of price in many potential trades.

We can't trust the marks we have seen to date because we believe the markets have experienced a secular shift in the value of financial assets and the ability of the U.S. economy to support employment and wage levels to the degree necessary to support anywhere near-par values on many classes of mortgage (and asset-backed) securities on a risk-adjusted, fair market value basis. Nevertheless, we believe that further pressure from regulators, and from the PPIP's introduction, will prove helpful in bridging remaining gaps between buyers and sellers of distressed structured securities. This is not to say that some institutions haven't played fast and loose with marks of so-called Level 2 and Level 3 assets (the typically junior or derivative classes, for which limited or no current real-market valuation is available). This has undoubtedly occurred.

Moreover, we are alarmed this week by the congressionally spawned pressure on the Financial Accounting Standards Board (FASB) to reverse much of the existing MTM guidance by allowing the banks even more discretion. The FASB will be voting today on changes, which we view as unwise, that

will enable banks to actually reverse some of their earlier write-downs to appear more profitable than they are for Q1 of this year. This will cloud the picture further (which is, of course, what the banks desire) and make it more difficult for the LSP portion of the PPIP to get underway. Of course, the notion of Congress and the UST working at cross-purposes is not unusual in American politics, but let's call it what it is.

The amount, however, of the really risky securities classes not previously written down, relative to whole loans, has shrunk to a point that such shenanigans are not the principal concern. The PPIP will help bridge some gaps in AFS valuation and, yes, the remaining securities valuation gap will put further pressure on bank capital but, believe it or not, MTM of bank-held mortgage securities is still not *the* problem for our banks going forward—measured by either size or the impact on how such institutions function.

Whole Loans and Capital Holes

The problem lies in the continuing degenerative impact of collapsing real estate values and an ongoing severe recession that places additional pressure on residential and commercial property values—seen in the context of the vast amounts of whole mortgage loan credit risk still very much alive and well on banks' balance sheets. Loans held-to-maturity or held-for-investment needn't be written down until they go bad—and, even then, not all that rapidly.

So, what's the problem then?

Our banking system was sitting on some $4.7 trillion of whole loan assets at the end of Q3 2008, secured by real estate mortgages (this excludes all non-real estate loans, which total another $3.2 billion and are generating their own losses). We have already seen a near 30% collapse in the value of residential real estate (which is still falling) and a substantial decline in commercial real estate values is well underway. Every day, more loans are becoming delinquent and defaulting—and are hitting banks' equity capital.

And what of that equity capital? Tier 1 Capital (with all of its bells and whistles) for the entire banking system totals just under $1 trillion as of Dec. 31, 2008. Tangible common equity of the banking system was only $863 billion. The FDIC tells us that, system-wide, the average Tier 1 Capital is about 10% of total assets. Banks are considered poorly capitalized when Tier 1 Capital falls below 6%—a buffer of merely $400 billion from present levels. Poorly capitalized banks are severely restricted in their ability to generate new loans and fulfill their overall missions in capital formation and commerce.

Looking at just the $3 trillion of banks' whole loans secured by residential real estate is instructive. We know that the vast majority of the loans on banks' balance sheets were made at very high percentages of bubble-era property values; let's assume that the original loan to value (versus peak values) of the average loan on bank balance sheets was 90% (it was likely higher, but let's give the benefit of the doubt). Let's further assume that the decline in value of residential real estate levels off at 35%, peak-to-trough. This would leave mortgage loans held by banks between 25% and 30% underwater as to collateral—an average collateral deficit of $1.3 trillion. This average, of course likely understating the damage because of the larger number of high advance-rate, bubble-era loans in the overall residential mortgage pool.

So, if only a third or so of the severely underwater residential mortgage whole loans default over time (to say nothing of commercial mortgages and non-real estate whole loans), the impact on banks' capital will be devastating—perhaps on the order of half a trillion dollars.

Those supportive of steady-as-she-goes options for the banking system are ignoring the massive yoke that underwater loans place on our financial system. They say we shouldn't move too aggressively to triage and recapitalize banks because we are discounting their ability to generate income to offset as yet unrecognized losses. They posit that the passage of time may yield recoveries on whole loan assets that exceed their value if sold today via a PPIP-like program. And since the assets need not be marked to market, they see no reason to act in ways they view as precipitous.

Basically, such opinions are identical to those voiced by the banking and government establishments in Japan during the 1990s. There was no MTM (in fact, there were no mortgage-backed securities) in Japanese banking after the collapse of their bubble in 1990. All bank loans were very much held for investment. (There was no history of trading bank paper in Japan; it was even repugnant from a cultural perspective to jettison bank assets.) So, they waited more than a decade to get bad loans off their balance sheets—and pretended they were solvent so as not to shut down the entire economy (and the global banking system went along with the charade because it was vulnerable, as well).

But that did not stop more loans from defaulting, year after painful year, making it impossible for the banks to establish sufficient excess capital to make new loans. Needless to say, the real estate market in Japan never staged the rebound to bubble-era values that the banks prayed for—and we have every reason to believe that prayer over the recovery of U.S. real estate values would yield the same result (for reasons we have written on at length in other reports).

That is not, of course, the American way to handle a banking crisis. It is not consistent with our nature. But it is important to understand the following:

(i) Our banking regulatory system was not designed to withstand a meltdown of the present magnitude, and changing the rules in a retroactive sense has potential legal consequences in a country dedicated to the protection of property rights;

(ii) Marking to market of whole loans on bank balance sheets, and leaving them there, would have the same effect as that feared by the Japanese in the '90s—the immediate insolvency of the banking system.

(iii) It is decidedly in the interest of bank shareholders (and their management) to delay recapitalization as long as possible, as under present circumstances, they would likely be wiped out. It is therefore reasonable to conclude that bank management won't act unless forced to do so to preserve "optionality." And speaking just for Westwood's own debt restructuring business, it is clear that whole loan lenders continue to be willing to jump through hoops to avoid write-downs of any sort.

PPIP Perfected

Given the magnitude of the whole loan dilemma, and the importance of getting good capital (cash) into the banks, we see the LLP as an excellent first move on the part of the UST and the FDIC. The LLP, if successful, will create the price discovery necessary to determine which institutions need to be seized, merged, or in the cases of the larger and systemically critical institutions, recapitalized by public and/or private capital. Further, it should minimize the immediate losses to the Deposit Insurance Fund (DIF) and allow for participation by the DIF in any future recoveries by the funds established under the LLP.

The LLP, however, is faced with a conundrum whose mere introduction raises it to a level of forced consideration: how to get banks that are not otherwise required to mark whole loans to market to offer them for sale at assuredly sizable discounts.

We are hardly the only folks to point this out; pretty much all of the seemingly infinite number of the PPIP opponents have raised the issue as number one in their list of ineffective program elements. But, unlike the detractors, our own interaction with senior officials of the FDIC has left us convinced that Chairman Sheila Bair and her policy people are more than well aware of the issue and are planning to use their position as the banks' most active regulator to pressure them to relieve themselves of troubled loans.

While reexamining all 8,400 banks in this country would prove an impossible task, we are somewhat fortunate in that 679 banks with assets over $1 billion hold approximately 90% of bank assets. By now, we are all aware that the government has placed the largest couple of dozen banks on regulatory treadmills for "stress tests" of their overall capitalization and asset base. Those "systemically critical" institutions will have their internal valuations and regulatory accounting practices analyzed in some depth under various assumptions about future market conditions. We frankly expect this to be the first of several rounds of such testing of large banks, as the first-round assumptions prove challenged by future facts on the ground, as it were. Over time, the weaker banks will be consolidated into the stronger ones, with the stronger ones receiving additional public and/or private capital to permit their full remediation.

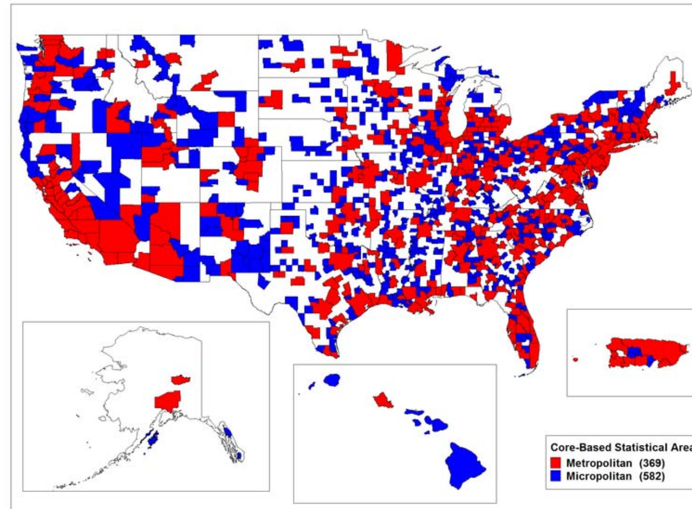
The foregoing process, however, is impractical in the case of most other large banks. Therefore, we would propose an alternative regime for the banks in excess of $1 billion in assets— including the largest banks—to determine which assets must be exposed to market valuation and sale through the LLP.

Our proposal would be to have the FDIC, through a standardized approach, conduct a simplified Emergency Asset Review Protocol (EARP) of each such bank's mortgage loan portfolio, on the following basis:

- All whole mortgage loans made from July 1, 2003, through June 30, 2008, should be considered for review. These five years constitute a reasonable enough approximation of the bubble period to ensure that a very high percentage of potentially problematic loans are included.

- We would suggest that the EARP be applied to whole mortgage loans of types most likely to be severely impaired to narrow the task. These would include residential 1 to 4 family, HELOCs, all subordinate mortgages, land loans, hotel loans, commercial office building loans, retail property loans and specialty property loans. Multifamily (rental housing) loans would be generally excluded, as would farm loans.

- Loans made on properties in certain areas of the country would be exempt from the review. We would suggest excluding properties in states containing no metropolitan statistical area (MSA) ranked in the top 75 MSAs in the country. We would also suggest excluding properties located outside the boundaries of an MSA (the red areas on the map below) or in any MSA with a population of less than 500,000 (about the top 100). Since the vast majority of the bubble's impact was felt in more urbanized areas, limitations such as these make sense.



- With respect to whole residential mortgages, banks would be required to disclose the original appraised values upon which the loans were originally made. See below if the loan did not originally require an appraisal or if the original appraisal cannot be located.

- As a proxy for the deterioration of value of whole residential mortgage loans, we would suggest using the Case-Shiller index for properties within the 20 MSAs covered by the index; for those properties in smaller MSAs, we would utilize the index for the nearest Case-Shiller MSA. This will be somewhat inexact, but will simplify the process of choosing which loans should be exposed for auction under the LLP.

- The approximate current values (the "Conditional Value") of the reviewed residential properties would be calculated by taking the original appraised value, dividing it by the relevant Case-Shiller index value from the date of the original loan appraisal, and then multiplying the result by the most recent Case-Shiller index value.

- Loans for which Conditional Values of the properties acting as collateral have declined to a point at which the Conditional Value is less than 85% of the outstanding amount of the mortgage loan shall be deemed "Materially Impaired."

- Commercial property loans would be deemed Materially Impaired if the borrower's most recent quarterly or annual statements indicate that annualized cash flow from the property collateralizing the loan is insufficient to make payments of interest and principal on the loan, pursuant to the loan's original terms (and not as the result of a workout or subsequent compromise, unless the loan has already been written down to reflect such compromise). Construction and land loans on which debt

service is being paid from a reserve account shall be considered Materially Impaired if they are "out of balance" in accordance with their original terms.

- The FDIC would require all banks subject to the EARP to offer Materially Impaired loans for sale under the LLP or to be written down to their level of Material Impairment. Banks should be permitted to establish reserve prices for Materially Impaired loans, but those that do not trade under the LLP should be marked to their reserve prices on the banks' books.

- For purposes hereof, residential loans for which an original appraisal is not available, or was not originally required, should be deemed Materially Impaired unless the holding bank commissions a current appraisal of the underlying collateral to prove otherwise.

- In addition to Materially Impaired loans, the FDIC should require all nonperforming whole mortgage loans held by banks to be offered for sale through the LLP or written down to a level consistent with their measure of Material Impairment. For this purpose, the definition of a nonperforming loan should include all loans on which borrowers had previously been paying interest, but have ceased to do so— regardless of the existence of an interest or other cash reserve from which a bank may be drawing to keep the loan nominally current.

The EARP's purpose is to identify loans constituting the most severe ongoing encumbrance on banks' ability to continue lending. These Materially Impaired loans, by virtue of their severe under-collateralization, have a higher probability of default, and—if not off-loaded or otherwise resolved—will be clogging the banking system for years.

There are a few other tweaks we would like to see added to the mix with respect to the LLP. Because the LLP will be focused, at least initially, on real estate loans, we believe that auction packages should aggregate loans offered for sale by multiple institutions, sorted into pools of homogeneous property types and separated—to the greatest extent possible—by major regional areas of the country. Because it is assumed that many of the commercial mortgages acquired by Public Private Investment Funds (PPIFs) will ultimately default and be foreclosed upon, the PPIFs should be permitted to engage in further development and improvement activities to maximize the eventual sales value of the properties for the investor's and government's benefit. With respect to commercial properties with granular sales activities (unfinished/unsold condominium buildings or residential development land, for example), PPIFs should be granted the ability to revolve sales proceeds over a finite fund term of five to seven years to fund their continuing activities. These practical considerations, unique to real estate, should be carefully considered by the FDIC.

Making the Best of a Bad Situation

We believe the PPIP is a necessary part of what should be a two-part plan to re-regulate and revive our presently moribund banking sector. We see no better way of preventing troubled assets from continuing to weigh down the ability of U.S. banks to function normally—other than to remove them or segregate them. The segregation route—essentially having the government act as aggregator into a "bad bank"—has been justifiably rejected because of concerns over establishing transfer pricing. The PPIP resolves this dilemma and has the added advantage of getting the government out of the asset management business—or establishing a management contracting enterprise subject to its own potential abuse. The

alignment of the public's interest with that of private capital is the core element of the PPIP that gives us the greatest comfort.

But the LLP component of the PPIP will not be effective unless the FDIC couples it with an aggressive, though fairly and evenly applied, effort to push the banks they regulate to divest of their problem loans. It is unreasonable to expect banks to line up to sell assets that will result—in the aggregate—in losses that lead to their near-term regulatory or actual insolvency. Yet that will surely be an outcome for some institutions, and the FDIC must stand ready to protect its interest as depository insurer by using the LLP to minimize losses by avoiding a fire sale at the time of bank seizures. The approach we have suggested makes sense to us, but it is by no means the only way to skin the cat.

We have not hesitated to call the FDIC out (or any branch of government, for that matter) when we felt they were headed in the wrong direction during this crisis. (For example, we continue to disagree with Chairman Bair's position on how to best effectuate mortgage relief for underwater borrowers.) Our contacts with the FDIC, however, before and after the plan's announcement have indicated that its leaders and policymakers are well aware of the challenge that faces them. What encourages us is not as much their awareness of these challenges, but rather the dynamism that Ms. Bair and her team show in coming up with proposed solutions and working the issue. They are not home yet, but they are now a full member of the team with the UST and FRB—and have stepped up to the plate with great determination.

Westwood Capital, on its own and on behalf of clients, expects to participate in the Legacy Loans Program.

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