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Proposed Public-Private Investment Program Presents Opportunities, Risks for Credit Market Participants

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Introduction

On March 23, 2009, the U.S. Department of the Treasury issued a press release and posted additional materials to its website providing added detail on its previously announced "Public-Private Investment Program". As described in the materials provided by the Treasury, which we refer to as the Treasury "Proposal",[1] the Public-Private Investment Program will in fact consist of two separate programs, one of which will in turn have two parts. Although divided into these different programs and parts, the essence of the Proposal is that the Treasury, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve will together provide as much as $1 trillion in the form of equity capital, non-recourse loans, and guarantees of non-recourse loans for the purchase by private investors of pools of distressed assets from certain financial institutions. Those distressed assets are expected to initially include residential and commercial mortgage loans and securities backed by such loans, but the program may be expanded to include additional troubled assets over time.

Because of the generous amount of government financing that will be available under the Public-Private Investment Program, the program may provide unusually attractive opportunities for experienced credit market investors. Those wishing to take advantage of these opportunities, however, should carefully assess the details of Treasury's Proposal. Many of these details will need to be provided by Treasury in coming weeks. Potential investors should also carefully consider potential risks of participating in the Public-Private Investment Program, including the likelihood that such participation may be heavily regulated by the Treasury, the FDIC and the Federal Reserve.

Legacy Loans Program

The first half of the new Public-Private Investment Program is the "Legacy Loans Program", which will be administered in large part by the FDIC, and the funding for which will be in the form of private investments, loans guaranteed by the FDIC, and equity investments made by the Treasury out of amounts remaining under the $700 billion Troubled Asset Relief Program (TARP). These funds will be used to purchase distressed mortgage loans, and possibly other distressed assets, from federally insured banks and savings associations. The FDIC is currently seeking public comment and discussing the terms of the Legacy Loans Program with stakeholders and intends to finalize the terms of, and launch, the program in the near future.

Overview of Legacy Loans Program

The goal of the Legacy Loans Program is to generate returns for both taxpayers and private investors through opportunistic investments using a long-term "buy and hold strategy" or other strategies involving limited trading of assets. At the same time, the Treasury intends for the program to help remove troubled legacy loans from bank balance sheets and therefore, make it easier for banks to access capital markets and increase their lending.

Under the program, public-private investment funds (PPIFs) will be established by the FDIC to own and manage pools of assets that will be sold to the PPIFs from insured U.S. banks and savings associations. These PPIFs will fund the purchase price for these assets through a combination of equity contributed 50% by the Treasury and 50% by private investors and non-recourse loans made by the selling banks and guaranteed by the FDIC in amounts of up to six times each PPIF's equity capital. Financial institutions interested in selling assets under the program will work with their primary federal regulators to identify assets to be sold. In order to be eligible to participate in the program, these assets must meet certain minimum requirements that will be established by the FDIC. Once assets are identified, the FDIC will, with the help of a third party valuation firm, produce an initial valuation for each pool of assets and determine the amount of leverage each such portfolio will be able to support.

The Treasury and the FDIC expect that the private investors that participate in the program will include, among others, financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds and pension funds. All participating investors will have to be pre-approved by the FDIC. Joint bids from groups of investors will be permitted, but collaboration among different bidding groups will not be allowed after the start of an auction, and investors will be prohibited from investing in any PPIF that purchases assets from any of its affiliates. The Treasury and the FDIC also intend to encourage participation by small, veteran-, minority- and women-owned firms.

Private bidders who are pre-approved by the FDIC will be entitled to bid on predetermined pools of assets in auctions administered by the FDIC. In order to be eligible to make a bid, an investor will be required to make a deposit equal to 5% of its bid value. Prior to the auction, the FDIC will inform participating investors of the amount of non-recourse debt that it will agree to guarantee with respect to the applicable pool of assets and confirm the percentage of equity that will be provided to the related PPIF by the Treasury. Participating bidders will then bid for the right to provide the remaining equity to the PPIF that will hold such assets.

Following a successful auction, the selling institution will be permitted to accept or reject the final bid. Assuming the selling institution agrees to the winning bid price, the winning bidder and the Treasury will purchase the equity in the PPIF formed to hold the relevant assets and the consideration paid to the seller will consist of the equity funds contributed by both the private investor and the Treasury and non-recourse, FDIC-guaranteed loans issued by the PPIF in favor of the seller. After the sale, it is expected that loans purchased by the PPIF will continue to be serviced by the selling bank, and the PPIF itself will be managed by a private asset manager in accordance with guidelines established by Treasury and the FDIC. PPIFs will be subject to certain oversight and reporting requirements and will be required to pay the FDIC ongoing administration fees and an annual guarantee fee.

Issues for Consideration by Participants in the Legacy Loans Program:
As described above, private investors will have access to substantial government financing for the purchase of eligible assets under the Legacy Loans Program. A number of important details regarding the program, however, have not yet been provided by the Treasury or the FDIC. These details include the process for determining the interest rates that will be charged on the non-recourse loans issued by the PPIFs, the process that will be used by the FDIC to establish the PPIFs, what legal structure the PPIFs will take, and what minimum requirements are going to be established by the FDIC for the loan pools.

In addition to the lingering lack of detail on some important points, set out below are some more specific issues that investors and investment managers interested in the Legacy Loans Program should consider:

• <u>Investor Eligibility</u>. It is unclear from the Proposal how investors will be chosen to participate in FDIC auctions conducted under the Legacy Loans Program. The Proposal states that participation in the program will be widely available to "an array of different investors, including, but not limited to, financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds and pension funds". However, each investor will need to be pre-approved by the FDIC and criteria for approval has not been provided. The FDIC has suggested that it will only approve foreign investors if those investors have a headquarters in the United States. Additional criteria may also be supplied.

• <u>Regulation of PPIFs and Participating Investors and Investment Managers</u>. The Proposal clearly provides that PPIFs established under the Legacy Loans Program will be subject to FDIC oversight, and in connection with that will be required to cooperate with the FDIC and provide it with certain information. It is less clear whether the PPIFs, their investment managers, or even participating investors might be subject to additional regulation because of their participation in the program, such as regulation under the Emergency Economic Stabilization Act (EESA). It appears that the Treasury will regard at least the PPIFs to be recipients of TARP funds, and therefore potentially subject to any regulations that are applicable to such recipients. The Proposal also clearly provides that the PPIFs will be required to agree to "waste, fraud and abuse protections" to protect taxpayer funds. All of this raises the possibility that participants could unwittingly become subject to executive compensation and other regulations that have caused so much concern in the financial services industry.

• <u>Indeterminate Auction Outcome</u>. It appears that selling financial institutions will be permitted to reject the winning bid at the end of the FDIC's auction. This means that an investor who goes through the expense related to making a bid will have no guarantee that it will be able to purchase a pool of assets under the program, even if it wins the auction with respect to that pool. All of these expenses would be entirely borne by the private investor.

• <u>Possibility of Non-Investor Administration of PPIFs</u>. The Proposal states that the PPIFs will themselves be run by asset managers, which will be required to be approved by the FDIC. It is not clear what authority the participating investor will have to appoint or remove this manager, and there is a possibility that a winning investor, even if such investor is itself a professionally managed investment fund, might find itself participating in a PPIF that is managed by a different manager that has been approved by the FDIC.

• <u>Affiliate Provision</u>. The Treasury is concerned with the possibility that banks holding eligible assets might bid up the value of their own assets with government funds, and thus has provided in the Proposal that no investor may invest in a PPIF if it is an affiliate of the seller or if the seller represents 10% or more of its private capital. Potential investors organized as investment funds should be mindful of this limitation when accepting subscriptions.

• Servicing of Loan Pools. The Proposal states that the selling banks will generally service the loans held by the PPIFs, but does not specify in what circumstances (if any) private investors will be able to take over such servicing.[2]

• Fees. The Proposal provides that the FDIC will be periodically paid administration and guarantee fees by the PPIFs for its oversight of the PPIFs and its guarantees of their debts. Investors will need to receive additional details regarding the amount of these fees.

• Treasury Warrants. Because the Treasury will be investing TARP funds in the PPIFs created under the Legacy Loans Program, Treasury believes that Section 113(d) of the EESA requires it to receive a warrant in connection with its investment. The Proposal states that the warrants in this case will be issued by the PPIFs but does not provide any additional terms of such warrants. Details about the warrants, including what securities will underlie such warrants, will be important to any private investor considering investing in a PPIF.

• Opportunities to Conduct Due Diligence. It is unclear what information will be available to auction participants regarding the pooled assets and what due diligence potential bidders will be permitted to conduct with respect to such assets. The Proposal does provide that participants will receive at least some diligence information on the underlying assets, including certain information provided by the selling bank to the FDIC.

• Likelihood of 50% Equity Participation by Treasury. In a recent press conference on the Legacy Loans Program, the Chairman of the FDIC, Sheila Bair, noted that the FDIC was particularly interested in receiving commentary on the equity split between private investors and the Treasury. She commented that increased private sector investment was helpful to ensure fair pricing was obtained for the assets but that if investments were successful, the higher the percentage of private equity, the lower the overall return by taxpayers. Although the FDIC and Treasury determined that a 50-50 split of equity strikes the right balance, she indicated that this provision continues to be under review by regulators.

• Encouragement for Participation by Certain Investors. The Proposal states that participation by small, veteran-, minority-, and women-owned firms in the Legacy Loans Program will be encouraged, but does not specify what form that encouragement will take.

• Opportunities for Valuation Experts. Under the Proposal, the FDIC will contract with third-party valuation experts to value each pool of assets that is auctioned off by the FDIC. Although no details as to how these experts will be chosen have been given, the Legacy Loans Program potentially presents opportunities for experienced credit managers even if those managers do not want to bid in the auctions conducted under the program.

Legacy Securities Program

The second part of the new Public-Private Investment Program is the "Legacy Securities Program", which will be administered and financed by the Treasury and the Federal Reserve. The Legacy Securities Program will itself consist of two separate parts, both of which will focus on the purchase of asset-backed securities issued prior to 2009 from financial institutions that are eligible for TARP funding. The Treasury and the Federal Reserve believe that the market for these assets has deteriorated beyond levels that could be explained by their fundamental values, and intend for the Legacy Securities Program to draw private capital back into these markets.

TALF Expansion:
Under the first part of the Legacy Securities Program, the Federal Reserve is expanding the Term Asset-Backed Securities Loan Facility (TALF) program. As the TALF program is currently conducted, the Federal Reserve provides non-recourse loans to "eligible borrowers" that purchase certain highly-rated asset-backed securities. "Eligible borrowers" under the program include (i) business entities or institutions organized in the U.S. (including U.S. subsidiaries of foreign entities), (ii) U.S. branches or agencies of foreign private banks that maintain reserves with the Federal Reserve, and (iii) investment funds that are domiciled and managed from the U.S., in each case with exceptions for entities that are controlled by foreign governments. The amount the Federal Reserve will lend to eligible borrowers under TALF with respect to their eligible collateral is the market value of the collateral minus a percentage "haircut".

The Proposal states that under a new expansion of the TALF program, investors will be able to receive non-recourse loans from the Federal Reserve for the purchase of (i) non-agency residential mortgage backed securities that were originally rated AAA and (ii) commercial mortgage backed securities and asset backed securities that are currently rated AAA. No details have been given as to the haircuts that will apply to this collateral, whether there will be any change in the Federal Reserve's rules regarding "eligible borrowers" under the expansion, whether the Federal Reserve or the Treasury will be involved in the purchase by participating investors of the eligible assets, what additional items participating investors might be required to agree to with the Federal Reserve or what regulations such investors might be subject to,[3] or what fees and interest will be charged by the Federal Reserve with respect to the non-recourse loans provided by it under the new expansion.

PPIFs Program:
Under the second part of the Legacy Securities Program, the Treasury will initially provide funding from TARP funds to five or more PPIFs organized for the purpose of purchasing non-agency commercial and residential mortgage backed securities that were issued prior to 2009 and originally rated AAA or its equivalent. Fifty percent of the equity capital of these PPIFs will be provided by the Treasury and fifty percent will be provided by funds raised from private investors by private investment managers selected by the Treasury to manage PPIFs under the program. To be selected to manage one of the five initial PPIFs, a manager should (i) be able to show that it can raise at least $500 million of private capital for the program, (ii) be able to demonstrate that it has experience in investing in the type of assets covered by the program, (iii) show that it has a minimum of $10 billion of eligible assets already under management, (iv) be headquartered in the United States, and (v) be able demonstrate that it will be able to manage the PPIF consistent with Treasury's objectives. However, the Treasury has stated that it will review applications on a "holistic basis" and that failure to meet one of these criteria might not disqualify an otherwise qualified applicant. In addition, the Treasury has stated that it will consider opening the program for smaller fund managers after choosing the managers of the first PPIFs, that it will consider choosing more than five fund managers initially if it receives applications from enough qualified managers, and that it will seek to encourage participation in the program by small, veteran-, minority-, and women-owned investment managers, including by encouraging such investment managers to partner with other private asset managers to meet the high eligibility standards.

After being selected, the participating fund managers will be given 12 weeks to raise at least $500 million of private capital. The capital raised will be invested by the participating investors into a newly created fund vehicle, which in turn will invest in a PPIF with the Treasury. The Treasury will match the equity raised for the PPIF from private investors, and may also provide non-recourse leverage to the PPIFs of up to 100% of the PPIF's total equity capital.

Thus, $500 million of private capital could be matched by the Treasury by $500 million in equity capital and up to an additional $1 billion in non-recourse loans. Finally, the Proposal states that the PPIFs may also be eligible participants in the TALF extension described above, so that additional funding might be provided to the PPIFs by the Federal Reserve under that program.

The Proposal does not, however, contain any guarantees as to exactly how much leverage will be provided to each PPIF. The level of leverage provided to any PPIF will depend on, among other things, the amount of other debt financing received by the PPIF. Thus, the Treasury has stated that (i) PPIFs that receive only equity under the program will likely be permitted to obtain an unlimited amount of debt financing under other government programs or from private sources, (ii) PPIFs that receive leverage under the program of up to 50% of their equity capital will also be permitted to obtain debt financing under other government programs and from private sources, but subject to leverage covenants to be agreed to with the Treasury, and (iii) PPIFs that receive leverage in the program in excess of 50% of their equity capital will likely not be permitted to obtain additional leverage under any other government program or from any other source.

Issues for Consideration by Participants in the Legacy Securities Program:
As stated above, the primary issue for potential investors in the portion of the Legacy Securities Program consisting of an expansion by the Federal Reserve of the TALF program is that very little detail has been provided regarding such expansion. Although more information has been provided regarding the second part of the Legacy Securities program, some important terms remain unexplained. Set out below are some specific points that investors and investments managers interested in this second part of the Legacy Securities Program should consider:

• <u>Application Deadline</u>. Fund managers should be aware that the deadline for submitting an application to be one of the initial fund managers managing a PPIF under the Legacy Securities Program is April 24, 2009. A copy of the application is available on the Treasury website at http://www.treas.gov/press/releases/reports/legacy_securities_ppif_app.pdf.

• <u>Regulation of PPIFs and Participating Investors and Investment Managers</u>. It is not clear whether PPIFs or investment managers might be subject to additional regulation, such as regulation under EESA, because of their participation in the Legacy Securities Program. It appears that the Treasury will regard at least the PPIFs to be recipients of TARP funds, and therefore potentially subject to any regulations that are applicable to such recipients. The Proposal also clearly provides that the PPIFs will be required to agree to "waste, fraud and abuse protections" to protect taxpayer funds and that fund managers will be required to provide access to the PPIFs' books and records to the Treasury. Anticipating concerns in this regard, the Treasury has at least stated that passive private investors in the PPIFs will not be subject to any executive compensation restrictions.

• <u>Treasury's Right to Cease Funding</u>. The Proposal states that Treasury will retain the right to cease funding the debt and equity capital that it has committed to a PPIF at any time.

• <u>Governance of PPIFs</u>. Although the Proposal states that fund managers will control asset selection and pricing as well as the process of asset liquidation, trading and disposition, the PPIFs will be heavily regulated by the Treasury. For example, the Treasury has stated that the PPIFs will "predominantly [follow] a long-term buy and hold strategy" and that it will only allow hedging by PPIFs as appropriate in light of such strategy. The Proposal also provides that the PPIFs will have terms of no more than 10 years, that the Treasury will consider fees charged to private investors in choosing fund managers, that management fees and expenses paid with respect to the Treasury's investment can only be paid out of distributions receivable by the Treasury, and that no carried interest will be charged with respect to the Treasury's investment. In addition, private investors in the private investment vehicle that invests in a PPIF will not be permitted to withdraw from that vehicle earlier than the third anniversary of such vehicle's first investment and the Treasury will likely require such vehicles to accept investments by ERISA investors. Other details, such as whether the proceeds of the PPIF's investments might be recycled, will apparently be negotiated by selected fund managers and the Treasury.

• Conditions to Non-Recourse Loans. In addition to the governance provisions mentioned above, each PPIF will be required to agree to additional restrictions in order to obtain non-recourse loans from the Treasury. In order to receive such loans in an amount of up to 50% of the PPIF's equity capital, fund managers will have to agree that private investors will not be given voluntary withdrawal rights and will have to agree to leverage covenants limiting their access to additional leverage from other government programs and private sources. In order to be considered for additional non-recourse loans in excess of 50% of the PPIF's equity capital, fund managers will likely be prohibited from obtaining other debt financing from the government or the private sector, and will have to agree to additional restrictions, including "restrictions on asset level leverage, withdrawal rights, disposition priorities and other factors Treasury deems relevant".

• Affiliate Provision. A PPIF formed under the Legacy Securities Program will not be permitted to purchase assets from or sell assets to (i) affiliates of its own fund manager, (ii) private investors in the fund participating in such PPIF that have committed 10% or more of such fund's private capital, or (iii) any other fund participating in the program. Potential investors organized as investment funds should be mindful of the first two limitations when accepting subscriptions.

• Reporting Requirement. The managers of PPIFs under the Legacy Securities Program will be required to provide reports to the Treasury monthly, which are to be based on third-party sources and audited annual valuations, detailing purchases and sales by the PPIF, current valuations of the PPIF's assets, and the PPIF's profits and losses. There is no discussion in the Proposal about whether such information will be made publicly available.

• Foreign Collateral and Fund Managers. The Proposal provides that the assets underlying any securities purchased in the program "must be situated predominantly in the United States". Participating fund managers will also need to be headquartered in the United States.

• Treasury Warrants. The Treasury has provided that it is required by Section 113(d) of EESA to receive warrants in connection with its investment in each PPIF. The Proposal does not provide any detail regarding the term of these warrants.

Conclusions

The Public-Private Investment Program is being established by the Treasury, the FDIC, and the Federal Reserve to use a combination of market incentives and government money to revive the trading markets for mortgages and mortgage related securities. The success of the program, however, will require participation by professional credit market investors. The problems presented by some of the details of the Treasury's Proposal may be insurmountable for some of those investors, while others will find them acceptable as long as careful planning is undertaken. All potential participants should understand that investments in the program will be subject to substantial regulation by the Treasury, the FDIC, and the Federal Reserve, and that currently unforeseen adverse regulation from these entities or other governmental actors, imposed after a participant's investment, remains a real possibility in the current political environment. But for experienced credit market participants who understand these details and have taken them into the account in the structuring of their investment vehicles, and who are prepared to weather the possibility of adverse regulatory developments, the Treasury's plan may also present unusually attractive opportunities.

1.These materials were updated by the Treasury on April 6, 2009. The updated versions are available at http://www.financialstability.gov/roadtostability/publicprivatefund.html.

2. FDIC officials have made statements, however, suggesting that private investors will ultimately retain the right to service the PPIF's assets. See http://www.fdic.gov/llp/transcript.html.

3. The TALF program has failed to attract interest from certain potential investors because of certain Federal Reserve reporting and inspection rights contained in the form loan agreements used for the program.