Treasury Unveils Public-Private Investment Program for Legacy Assets

On March 23, the U.S. Treasury (UST), in conjunction with the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve, unveiled the Obama administration's plan to purchase troubled or “legacy” assets that are currently clogging the balance sheets of U.S. financial institutions. The Public-Private Investment Program (PPIP) is expected to generate $500 billion of purchasing power (with the potential to expand to up to $1 trillion over time) to buy legacy assets by combining capital from private investors with $75 to $100 billion in UST-provided TARP equity, which will then be substantially leveraged with debt guaranteed by the FDIC and/or issued by the UST and the New York Federal Reserve Bank (NYFRB).

The PPIP consists of three main elements: (i) a Legacy Loan Program to form Public-Private Investment Funds (PPIFs) to purchase residential and commercial real estate loans (Legacy Loans), (ii) a Legacy Securities Program to form PPIFs to purchase asset-backed securities backed by legacy loan portfolios (Legacy Securities), and (iii) an expansion of the NYFRB's Term Asset-Backed Securities Loan Facility (TALF) to allow highly leveraged purchases of Legacy Securities with NYFRB TALF loans. The following is a description of these three elements of the PPIP along with issues and considerations for potential participants that have been identified by Katten's TARP Task Force.

Legacy Loan PPIF Program

The Legacy Loan Program will facilitate the creation of individual PPIFs to purchase legacy loan pools through a program that will combine equity capital from the private sector and the UST with leveraged debt financing (with up to a 6-to-1 debt-to-equity ratio) issued by each PPIF and guaranteed by the FDIC.

How the Legacy Loan Program Works

Eligible U.S. financial institutions that are insured by the FDIC, working together with their primary federal banking regulators, the FDIC and the UST, will identify pools of Legacy Loans to be sold under the Legacy Loan Program. The FDIC will select a third party valuation firm to conduct an analysis of the assets and, depending on the credit quality of the loans and other factors, the FDIC will determine the permissible debt-to-equity ratio for the PPIF, which may be as high as 6-to-1. Groups of private investors that have been pre-qualified by the FDIC (through a process yet to be described) will bid on the asset pool in an auction conducted by the FDIC, and the highest bidding private investor will set the price for the asset pool. The

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1 Eligible private investors will include, but not be limited to, financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds and pension funds. Certain other restrictions applicable to investors are set forth on page 3 under “Investor Restrictions and Obligations.”

2 For a bid to be considered, it must be accompanied by a refundable cash deposit in the amount of 5% of the bid value, which will be returned if the bid is unsuccessful or rejected by the bank.
FDIC will then guarantee debt issued by the PPIF to the selling bank in an amount set by the approved debt-to-equity ratio, and the remaining equity obligation will be contributed equally by the winning private investor group and the UST. If the selling bank accepts the purchase price, the cash from the equity investment and the debt issued by the PPIF will be paid to the selling bank (and the selling bank may then, at its option, retain the debt or sell some or all of the debt to a third party investor for cash). The FDIC is essentially allowing the seller to provide the PPIF with seller financing guaranteed by the FDIC.

For example, if $84 were the highest bid received from any private investor group for a pool of Legacy Loans with a face value of $100, and the FDIC were to assign that pool the maximum 6-to-1 debt-to-equity ratio, then the FDIC would guarantee $72 of debt issued by the PPIF, the UST would contribute $6 of equity, and the private investor group would contribute $6 of equity.

Once the assets have been purchased by the PPIF, private fund managers will control and manage the assets until final liquidation, subject to rigorous FDIC oversight. Servicing may initially be provided by the selling bank, but the PPIF will purchase the servicing rights and retain control of servicing throughout operations, subject to relevant agreements.

Investors will share profits and losses in proportion to the equity invested. Each PPIF will be required to maintain a debt service coverage account to ensure that working capital is sufficient to meet anticipated debt service obligations, interest and operating expenses. A portion of cash proceeds from the sale of eligible asset pools will be retained by the PPIF until cash flow from eligible asset pools has fully funded the debt service coverage account, at which point escrowed cash will be released to the selling bank. Certain ongoing administrative fees will be paid to the FDIC by PPIFs for oversight functions performed by the FDIC, and the FDIC will charge an annual guarantee fee in exchange for its guarantee of the PPIF’s debt.

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3 Private investors may choose to take less UST equity, subject to a minimum which is yet to be determined. The UST may also adopt alternatives to UST capital so long as the alternatives do not diminish the collateral protection securing the FDIC guarantee and are capital neutral compared with the currently contemplated UST investment. The UST will not have control rights.
**Investor Restrictions and Obligations**

Private investors may not participate in any PPIF that purchases assets from sellers that are affiliates of such investors or that represent 10% or more of the aggregate private capital in the PPIF. Each PPIF must agree to waste, fraud and abuse provisions to be defined by the UST and the FDIC in order to protect taxpayers. Each PPIF will be required to make certain representations, warranties and covenants regarding the conduct of its business and compliance with applicable law. Each PPIF will provide ongoing information to the FDIC in performance of its oversight role for the benefit of the UST and the FDIC. The FDIC will provide duplicate reports to the UST.

**Issues and Considerations for Legacy Loan Program Participants**

The FDIC has begun a brief public comment period for the Legacy Loan Program, but at this point, many details of the program have not been provided and there are many unanswered questions, including the following:

**Terms of the Debt.** Many details regarding the terms of the FDIC-guaranteed debt have not been provided. For example, what will the maturity date be? What will the interest rate be? Will there be restrictions on prepayments of the debt? How will payments of principal on the loan pool be allocated among the holders of the debt and the holders of the equity? Will the initial “debt-to-equity” ratio be maintained throughout the life of the PPIF (similar to the allocation of principal on TALF loans) or will payments of principal on the loan result in amortization that effectively reduces the leverage provided by the FDIC-guaranteed debt? How will the warrants issued to the UST work in the capital structure of the PPIF?

**Management and Servicing of Loan Pools Held by PPIFs.** There is a great deal that has not been stated about how the day-to-day management and servicing of any PPIF’s loan pool would be conducted. The performance of residential and commercial loans, unlike securities, can vary widely depending on servicing performance and choices made by servicers regarding delinquencies, defaults and the disposition of assets. Almost no information has been provided about what type of servicing or actions with respect to loans would be allowed or required, except that residential loans would be subject to the Obama administration’s loan modification guidelines, and that servicing would likely initially be retained by the selling bank, but would be subject to control by the PPIF. No specific information has been provided about what restrictions, if any, will be placed on the disposition of assets, on how foreclosures and REO will be handled, whether there will be minimum holding periods for loans, or a host of other similar questions.

**Executive Compensation Restrictions.** The FDIC has stated that executive compensation restrictions will not apply to “passive” private investors in the Legacy Loan Program. However, especially in light of the political and media furor over AIG’s bonus payments, participants may justifiably be concerned that the definition of a “passive” investor has not been provided, and that it is unclear whether under the Emergency Economic Stabilization Act of 2008 (EESA) or the American Recovery and Reinvestment Act of 2009 (ARRA), the “recipient” of TARP funds would be the selling bank, the PPIF fund, or some other entity. The FDIC and the UST clearly believe that EESA requires that warrants be obtained by the UST from the PPIF, and this would only be necessary if the PPIF were viewed as the “seller” of a “financial instrument” to the UST, the purchase of which is necessary to promote financial stability. Under that analysis, the PPIF would be the recipient of TARP funds and would be subject to the executive compensation restrictions of EESA and ARRA. However, since many PPIFs may be special purpose entities with no employees or employees with nominal salaries, this may have little practical impact. For PPIFs structured as partnerships, however, it is possible that the general partners might be held to be subject to these onerous executive compensation restrictions.

**Pre-Certification Requirements for Private Investors.** Although the FDIC has stated that all investors will need to be pre-certified in order to bid on asset pools, no information has been provided at this time about the nature of these eligibility requirements. If the requirements for other FDIC auctions are used as a template, these requirements will likely bar individuals or firms that have been convicted of certain crimes or have been delinquent or defaulted with respect to certain obligations or debts.

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4 On March 26, in a conference call between the FDIC and industry participants, the FDIC clarified that it is intended that loans will be purchased by PPIFs “servicing released” which would give the PPIF the right, without cause, to replace the servicer with the PPIF’s preferred servicer or special servicer.
Ability of Selling Banks to Freely Choose Whether to Participate. The banks which could participate as sellers in the Legacy Loan Program are all subject to review by banking regulators, including the FDIC. In addition, a number of banks have received substantial capital injections through the Capital Purchase Program, and the largest U.S. banks are currently being stress-tested as part of the Capital Assistance Program, and may require further UST capital injections. In light of these facts, it would seem that any selling bank's decision whether to place any particular assets into a Legacy Loan Program auction, or whether to accept a winning bid, would be subject to significant regulatory influence, although the precise extent of that influence is not clear at this point. In any event, any decision whether to sell any particular asset would likely take into account any anticipated loss, and the consequent effect on the seller's capital, that would result from the sale. Another question is whether a seller bank will be permitted to have a reserve bid price that establishes a minimum bid, since the seller banks will have, at least in theory, the option to accept or reject a bid.

Participation by Smaller Banks. On March 23, FDIC Chairman Sheila Bair stated that a mechanism would be developed to allow smaller banks to pool their assets with those of other institutions in order to participate. However, no details have been provided on how this mechanism would actually function. For instance, how would the purchase price for a pool of assets be allocated among the various seller banks if the due diligence and leverage determinations were made on an aggregate non-individuated basis?

Legacy Securities PPIF Program

Similar to the Legacy Loan Program, the Legacy Securities Program will encourage the creation of PPIFs formed with a combination of private equity and UST equity that will then be leveraged with additional UST debt. These PPIFs will then be used to purchase eligible Legacy Securities on a leveraged basis, with the possibility of significantly increasing the leverage by also utilizing an expanded TALF program (as discussed below).

How the Legacy Securities Program Works

The UST has solicited applications from and will approve up to five asset managers to participate in Legacy Securities PPIFs to purchase “Eligible Assets.” These assets are initially defined to be commercial mortgage-backed securities and residential mortgage-backed securities issued prior to 2009 that were originally rated AAA by two or more nationally recognized statistical rating organizations (NRSROs) without external ratings enhancement and that are secured directly by the actual mortgage loans, leases or other assets and not other securities (other than certain swap positions as determined by the UST). Approved managers will have a certain period of time to raise private equity and the UST will match dollar-for-dollar the amount of private capital raised by the fund manager for each PPIF. Asset managers will be able to leverage their private and UST equity with senior loans made by the UST in an amount of up to 50%, or, subject to further conditions and restrictions, of 100% of the total equity capital of the PPIF. Finally, asset managers, at their option, may also apply to use the PPIF’s funds to obtain additionally leveraged loans from the NYFRB through the newly expanded TALF program once it is launched.

Applications must be submitted by April 10 and the UST expects to inform applicants of their approval or rejection prior to May 1. Criteria for qualifications as a fund manager are expected to include a demonstrable historical track record in the targeted asset classes, demonstrated capacity to raise at least $500 million of private capital, a minimum of $10 billion of eligible assets under management in the targeted asset classes, headquarters in the United States, and detailed structural proposals for the proposed legacy securities investment fund. Smaller asset managers may team up with larger managers in order to collectively meet the program’s qualification requirements, and small, veteran-, minority- and women-owned businesses are encouraged to apply.

These conditions may include restrictions on asset level leverage, redemption rights, disposition priorities and other factors the UST deems relevant.
Treasury equity capital will be drawn down in tranches to provide for anticipated investments (subject to limitations to be agreed with the UST), provided that UST equity capital may only be drawn down at the same time and in the same proportion as private capital. Debt financing will be secured by the PPIF’s eligible assets and funded concurrently with drawdowns of equity commitments. The UST’s senior debt will have the same duration as the underlying fund and will be repaid on a pro-rata basis as principal repayments or disposition proceeds are realized by the investment fund. Interest on the UST’s debt financing will be determined at a later date. The UST’s senior debt will be subordinate to any financing extended by the FRBNY under the TALF program. The UST retains the right to cease funding of committed but undrawn equity capital and debt financing in its sole discretion.

Fund managers will make proposals for the term of a fund with the intention to maximize returns for taxpayers and private investors, but in no event will the term be greater than 10 years, subject to extension with the UST’s consent. The fund manager has full discretion in investment and asset purchase decisions, although the funds will be expected to predominately follow a long-term by-and-hold strategy. Proceeds received by the fund will be divided between the UST and the private investors based on equity contributions, except that the UST will take warrants in the PPIF as required by EESA to protect the interests of taxpayers. Private investors may not voluntarily withdraw their investment prior to the third anniversary of the first private investment in the fund.

**Investor Restrictions and Obligations**

Fund managers will be required to present monthly reports to the UST and must agree to waste, fraud and abuse provisions to be defined by the UST. In addition, fund managers must agree to provide access to relevant books and records of the fund for the UST, the Special Inspector General of the TARP, and the Government Accountability Office. Very importantly, executive compensation restrictions will not apply to "passive" private investors in the Legacy Securities investment funds.7

**Issues and Considerations for Legacy Securities Program Participants**

*Ex Post Facto Changes to the Program/Political Considerations.* The political controversy over bonuses paid to certain AIG employees has made many investors cautious about participating in joint ventures with the government. It should be noted that for the Legacy Securities Program, the UST specifically retains the right to cease funding of committed but undrawn UST equity capital and debt financing at its sole discretion. This type of unilateral right to refuse committed funding without a reason may make certain participants reluctant to participate.

*Participation by Retail Investors and Benefit Plans.* The UST is requiring prospective asset managers to submit fundraising plans to include retail investors, if possible, in the PPIFs for Legacy Securities. The UST has also stated that it is anticipated that the PPIFs will be structured so that benefit plan investors, within the meaning of ERISA, will be eligible to participate as indirect investors in the funds. However, no details are yet available on exactly how retail and benefit plan investors will be able to invest in the PPIFs, and on what terms.

*Trading Strategy-Disposition of Securities.* The UST has stated that the PPIFs will generally follow a “long-term buy and hold” strategy, but that other strategies will be considered. No details have been provided about precisely how much latitude will be given to PPIF managers to develop trading strategies with respect to the Legacy Securities, or how to eventually dispose of the purchased securities. Primary dealers are currently developing structured products related to the TALF program that allow trusts to receive TALF loans and then sell pass-through certificates to investors, and similar financial innovation might result in re-securitizations or re-packagings of Legacy Securities held by PPIFs, depending on UST approval.

*Seller and Asset Eligibility Criteria.* The UST has stated that the loans and other assets purchased by PPIFs must be situated “predominately” in the United States, but that limitation is expressly subject to further clarification. Also, Eligible Assets currently may only be purchased from financial institutions from which the UST may purchase assets pursuant to Section 101(a)(1) of EESA, which would currently exclude hedge funds and other similar funds from being asset sellers.

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7 However, please note that concerns exist similar to those discussed on page 3 under “Issues and Considerations for Legacy Loan Program Participants—Executive Compensation Restrictions.”
Revisions to the TALF Program

In addition to the creation of PPIFs for the purchase of Legacy Securities, the TALF program soon will be expanded to include Legacy Securities. Under the current TALF program, the FRBNY is providing highly leveraged three-year non-recourse loans to investors to purchase newly originated asset-backed securities backed by a wide variety of recently originated credit exposures. Through this expansion of the TALF program, the FRBNY is expected to provide highly leveraged non-recourse loans to investors for the purchase of certain non-agency residential mortgage-backed securities that were originally rated AAA when they were issued, and outstanding commercial mortgage-backed securities and other asset-backed securities that are currently rated AAA. As previously stated, any PPIFs created under the Legacy Securities Program will be able, at their option, to obtain additional leverage for their purchases of Legacy Securities by purchasing those securities through the newly expanded TALF program.

The terms and conditions for the expanded collateral classes, including the applicable class haircuts, will be determined at a later date. Importantly, the FRBNY has stated that it is working to ensure that the duration of these loans will take into account the duration of the underlying assets. Investors in commercial mortgage-backed securities and residential mortgage-backed securities had expressed concern that the TALF program’s current three-year loan term limit would prove unworkable with respect to these types of longer duration assets.

Katten’s TARP Task Force

Katten Muchin Rosenman LLP’s multidisciplinary TARP Task Force advises clients on the U.S. Treasury’s Troubled Asset Relief Program created under the Emergency Economic Stabilization Act of 2008 and related government programs. Katten’s TARP Task Force advises clients that are (i) selling or purchasing legacy loans and securities through the Public-Private Investment Program, (ii) obtaining TALF loans and issuing and underwriting TALF-eligible asset-backed securities, and (iii) selling preferred shares to the UST in order to raise capital through the Capital Purchase Program or the Capital Assistance Program.