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Public-Private Investment: A Three Prong Program for Legacy Assets

BY ERICA BERG, CHRIS DANIEL, NICOLE IBBOTSON AND KEVIN PETRASIC

After weeks of anticipation and predictions, the U.S. Treasury Department ("Treasury") today announced its plans to address the troubled real estate-related assets that have been a significant source of the recessionary forces overhanging the U.S. economy. Treasury's approach to these legacy assets is three pronged: (1) a legacy loan purchase program ("Legacy Loans Program") using guarantees by the Federal Deposit Insurance Company ("FDIC"); (2) an expansion of the Federal Reserve Board's ("FRB") Term Asset-Backed Securities Loan Facility ("TALF"), and (3) the establishment of public-private investment funds to tackle legacy securities ("Legacy Securities Program"). Collectively, this three-prong program is referred to as the Public Private Investment Program ("PPIP").[1]

The PPIP addresses the two most significant legacy real estate-related assets that are held by all varieties of financial institutions, including banks, insurers, pension funds and individual retirement funds. The program will involve participation and coordination by Treasury, the FDIC and the FRB, depending on the facet of the program utilized. There are three principles underlying the design of the PPIP: (i) the purchase power is maximized through co-investment by the government and the private sector; (ii) risk and return is a shared concept through participation by the government and the private sector; and (iii) the private sector is better suited to price legacy assets. These principles become apparent upon closer review of the three parts to the program.

First Prong: Legacy Loans Program

The first prong of the public-private investment strategy involves legacy loans. Treasury and the FDIC are jointly launching the Legacy Loans Program which is designed to motivate the purchase of legacy loans to reduce the market overhang and help banks relieve themselves of the troubled loans on their balance sheets. The Legacy Loans Program involves the purchase by public-private investment funds ("PPIFs") of pools of loans and other assets from insured depository institutions pursuant to criteria established by the FDIC.[2] Individual PPIFs are formed to own and oversee individual pools of assets sold from banks. The FDIC will oversee the formation, funding and operation of the PPIFs, and will provide debt guarantees to PPIFs for a significant portion of their asset pool purchases.[3] Treasury will take an equity stake along with private investors and will oversee the management of its equity contributions to the PPIFs. The Legacy Loans Program process is summarized as follows:

1. A financial institution identifies those legacy loans and other assets they wish to sell as a pool of assets (the "Pool").

2. The FDIC analyzes what amount of funding of the Pool it is willing to guarantee, not to exceed a 6:1 debt to equity ratio.

3. The FDIC auctions the Pool and the highest bidder has access to the PPIF to fund 50% of the equity required for purchase of the Pool.

4. If the financial institution accepts the price, the buyer receives financing for the Pool in the form of debt guaranteed by the FDIC. The Pool serves as collateral for the guarantee.

5. Treasury and the buyer together provide the equity funding for the Pool, each investing 50%.

6. Private fund managers then control and manage the sold Pool until the underlying assets are finally liquidated, subject to strict oversight by the FDIC.

Banks interested in participating in the Legacy Loans Program should first work with their primary regulator to determine what pools of assets may be sold to PPIFs. The primary regulator will ensure that participating banks are identifying and selling assets that will instill maximum confidence in the market. After working with its primary regulator, an interested bank should then contact the FDIC to indicate interest in the Program. Servicing of loans and assets of a given pool sold to a PPIF under the Legacy Loans Program will be provided by the participating bank, unless otherwise specified.

Sample Investment under the Legacy Loans Program[4]

Step 1: If a bank has a pool of residential mortgages with $100 face value that it is seeking to divest, the bank would approach the FDIC.

Step 2: The FDIC would determine, according to the above process, that they would be willing to leverage the pool at a 6-to-1 debt-to-equity ratio.

Step 3: The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bid from the private sector – in this example, $84 – would be the winner and would form a Public-Private Investment Fund to purchase the pool of mortgages.

Step 4: Of this $84 purchase price, the FDIC would provide guarantees for $72 of financing, leaving $12 of equity.

Step 5: The Treasury would then provide 50% of the equity funding required on a side-by-side basis with the investor. In this example, Treasury would invest approximately $6, with the private investor contributing $6.

Step 6: The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis – using asset managers approved and subject to oversight by the FDIC.

Second Prong: Expansion of TALF

The TALF is implicated in the second prong of the PPIP. The first phase of TALF, or TALF 1.0, extended to a limited type borrower who maintained certain asset-backed securities ("ABS") as collateral for purposes of the TALF loans.[5] On March 19, 2009, the FRB extended the type of eligible collateral underlying TALF loans to the following securities: (i) ABS backed by mortgage servicing advances; (ii) ABS backed by loans or leases relating to business equipment; (iii) ABS backed by leases of vehicle fleets; and (iv) ABS backed by floorplan loans. These new securities are applicable for the next subscription and funding of TALF.[6] Today's announcement by Treasury of the PPIP extends TALF to certain legacy securities, in conjunction with the Legacy Securities Program. Eligible assets will include certain non-agency residential mortgage backed securities ("RMBS") that were *originally* rated "AAA" and outstanding commercial mortgage-backed securities ("CMBS") and ABS that are rated "AAA."

Though the extension of TALF is directly related to the final prong of the public-private investment strategy, details and terms of any subscription or funding involving TALF loans with such new RMBS and CMBS collateral underlying

them have not yet been provided by Treasury or FRB.[7] Of particular note, lending rates, minimum loan sizes and loan durations have not yet been determined for this extension of the TALF. Currently, the TALF has a three-year duration, but that duration is expected to be extended to as long as seven years to be able to get at RMBS and CMBS holdings. It is also unclear whether the FRB will hold the line at "AAA" ratings for these new asset classes.

Third Prong: Legacy Securities Program

The third prong of the PPIP is the Legacy Securities Program which involves the investment by PPIFs in legacy securities, which initially include CMBS and RMBS. The PPIFs involved in the purchase of such legacy securities are specialized PPIFs that will represent a joint investment by private investors and the Treasury (the "Funds"). The Funds will be managed by private sector fund managers who must apply for pre-qualification to raise funds to invest in the joint investment programs with Treasury. Approved fund managers will raise equity capital from the private sector and receive matching funds on a one-to-one basis from Treasury. The Funds will initially invest in RMBS and CMBS issued prior to 2009 that were *originally* rated "AAA" or an equivalent.[8] The loans and other assets underlying the securities must be located predominately in the U.S., subject to further clarification by Treasury. The eligible securities must be purchased by the Funds from financial institutions from which Treasury may purchase assets pursuant to Section 101(a)(1) of the Emergency Economic Stabilization Act of 2008. The Funds will seek a long term buy and hold strategy. Fund managers will make proposals for terms of their respective Funds, but no Fund will have a term of greater than ten years (subject to Treasury approval).

The sole investors in any Fund will be Treasury and a special purpose vehicle (SPV) controlled by the applicable fund manager. Private investors invest in the Funds through such SPVs. Treasury and an SPV will invest and divest in a given Fund on the same terms, proportionally, and at the same times. A Fund may obtain funding via secured non-recourse loans from Treasury in an aggregate amount of up to 50% of the Fund's total equity.[9] Funds may also finance the purchase of the eligible securities through TALF.[10]

Treasury is initially seeking to approve five fund managers to raise private capital.[11] Applications to become an approved asset manager are due to the Treasury by April 10, 2009; the Treasury intends to inform applicants of any preliminary approval on or prior to May 1, 2009.[12] The criteria for a fund manager upon which pre-approval may be granted by Treasury is anticipated to include:

- demonstrates ability to raise at least $500 million of private capital;
- demonstrates experience in investing in RMBS and CMBS;
- maintains a minimum of $10 billion of RMBS or CMBS under management;
- demonstrates capacity to manage the Funds consistent with Treasury's objectives, including protection of the taxpaying public;
- maintains its headquarters in the U.S.

Fund managers may charge fees at their discretion, which fees will also be considered in the Treasury's approval process. Treasury encourages diverse participation and seeks the involvement of small, veteran-, minority- and women-owned private asset managers to apply, or partner with other asset managers, if needed, to meet the various criteria for approval. Approved fund managers will provide monthly reports to Treasury and agree to allow the Special Inspector General of the Troubled Asset Relief Program, the Government Accountability Office, and their respective advisors and representatives access to books and records to

ensure appropriate oversight for taxpayer protection.

Sample Investment under the Legacy Securities Program[13]

Step 1: Treasury will launch the application process for managers interested in the Legacy Securities Program.

Step 2: A fund manager submits a proposal and is pre-qualified to raise private capital to participate in joint investment programs with Treasury.

Step 3: The Government agrees to provide a one-for-one match for every dollar of private capital that the fund manager raises and to provide fund-level leverage for the proposed Public-Private Investment Fund.

Step 4: The fund manager commences the sales process for the investment fund and is able to raise $100 of private capital for the fund. Treasury provides $100 equity co-investment on a side-by-side basis with private capital and will provide a $100 loan to the Public-Private Investment Fund. Treasury will also consider requests from the fund manager for an additional loan of up to $100 to the fund.

Step 5: As a result, the fund manager has $300 (or, in some cases, up to $400) in total capital and commences a purchase program for targeted securities.

Step 6: The fund manager has full discretion in investment decisions, although it will predominately follow a long-term buy-and-hold strategy. The Public-Private Investment Fund, if the fund manager so determines, would also be eligible to take advantage of the expanded TALF program for legacy securities when it is launched.

Further Details, and Challenges, to Come

Though the Treasury's announcement provided many details surrounding the PPIP, given the breadth and complexity of the program, there will be further details and clarification to come. Furthermore, though the program currently targets real estate-related loans and securities, the Treasury has indicated that it is open to the evolution and expansion of PPIP based on demand. As with other programs and strategies with the Treasury, FRB and FDIC, there is a certain "wait and see" aspect to PPIP that will determine expansion of scope and modification of terms.

While there are many challenges remaining in establishing and proving the effectiveness of the PPIP, perhaps the biggest obstacle remains the ability of Treasury Secretary Geithner and President Obama to overcome the firestorm on executive compensation still sweeping the Hill. The first test of the Administration's resolve to avoid having executive compensation issues derail the PPIP will come tomorrow morning when Secretary Geithner, FRB Chairman Bernanke and FRB of New York President Dudley testify on this issue before the House Financial Services Committee.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta

Chris Daniel
404-815-2217
chrisdaniel@paulhastings.com

Erica Berg
404-815-2294
ericaberg@paulhastings.com

Nicole Ibbotson
404-815-2385
nicoleibbotson@paulhastings.com

Washington, D.C.

V. Gerard Comizio
202-551-1272
vgeraldcomizio@paulhastings.com

Lawrence D. Kaplan
202-551-1829
lawrencekaplan@paulhastings.com

Kevin Petrasic
202-551-1896
kevinpetrasic@paulhastings.com

1 A summary of the terms of the overall program is available at http://www.treas.gov/press/releases/tg65.htm.

2 The process for the loans sales under the PPIP is very reflective of a recent structure utilized by the FDIC in its role as receiver of failed banks. See our prior Stay Current entitled "How to Buy Loans Originated by Failed Financial Institutions from the FDIC." (March 20, 2009).

3 As with the FDIC's Debt Guarantee Program under its Temporary Liquidity Guarantee Program, the FDIC will receive a fee for its guarantee. In addition, the FDIC-guaranteed debt would be collateralized by the loans in the purchased asset pools.

4 This sample investment is set forth in the Treasury's announcement of PPIP at http://www.treas.gov/press/releases/tg65.htm.

5 See our prior Stay Current entitled "The TALF Catalyst?" (March 17, 2009).

6 Subscriptions for the next TALF funding is due on April 7, 2009. The loans will settle on April 14, 2009.

7 For a general discussion of the subscription and funding process, refer to our prior Stay Current, "The TALF Catalyst?" (March 17, 2009).

8 Such rating is based on the ratings by two or more nationally recognized statistical ratings organizations, such as Moody's, Standard & Poor's or Fitch.

9 This debt financing is not available to Funds where the private investors have voluntary withdrawal rights. Treasury may also consider debt financing up to 100% of the equity of a Fund subject to certain restrictions being placed on the Fund, such as asset level leverage, withdrawal rights, disposition priorities or other terms Treasury may deem necessary.

10 This financing is subject to further detail necessary from Treasury. Treasury equity capital and SPV capital must be leveraged proportionately.

11 The Treasury may consider an expansion of the program dependent on future fundings.

12 Applications may be obtained at http://www.treas.gov/press/releases/reports/legacy_securities_ppif_app.pdf.

13 This sample investment is set forth in the Treasury's announcement of PPIP at http://www.treas.gov/press/releases/tg65.htm.