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The Financial Stability Plan: Treasury Announces the Public-Private Investment Program

The Economic Crisis Response Group is monitoring closely new developments in response to the current turmoil affecting the world's financial markets and institutions and provides updates and analysis on key initiatives to address this crisis.

This alert focuses on the Treasury Department's Public-Private Investment Program, the details of which were released on March 23, 2009.

The Public-Private Investment Program

The Public-Private Investment Program ("PPIP") is designed to unlock credit markets by removing "legacy assets" from the balance sheets of banks and other financial institutions. "Legacy assets" fall into two categories: (i) real estate loans held directly on the books of FDIC-insured banks ("legacy loans") and (ii) certain securities backed by loan portfolios held by entities which qualify for TARP assistance ("legacy securities"), both of which currently have indeterminate market values.

Under the PPIP, the Treasury will partner with private investors to establish investment funds for the purpose of purchasing such legacy assets (the terms being somewhat different for funds formed to purchase distressed loans and those formed to purchase mortgage-backed securities). The Treasury's objective is to encourage private investors to re-enter the market for legacy assets, which largely have been frozen since September 2008.

The Treasury, in conjunction with the FDIC and the Federal Reserve, has implemented two component programs under PPIP to address legacy assets: 1) the Legacy Loans Program to remove legacy loans from bank balance sheets and 2) the Legacy Securities Program to remove legacy securities from bank balance sheets and create a market for such securities.

Legacy Loans Program

According to the Summary, Participant Banks would approach the FDIC with a portfolio of eligible loans which it wishes to offer to "sell" through PPIP; the FDIC would do the preliminary diligence and determine, in discussion with the selling bank, the appropriate valuation for such loans (using the services of a third-party valuation firm retained by the FDIC), as well as the amount of "seller financing" that would be required from the Participant Bank (but which financing would be guaranteed by the FDIC), and then offer that pool to pre-qualified members of the investing community through a bidding process.

The Legacy Loans Program provides for the creation of multiple public-private investment funds ("PPIFs") to purchase eligible legacy loans from participating banks under criteria established by the FDIC. Under the program, the U.S. Treasury matches equity investments in the PPIF made by private investors dollar for dollar, and the FDIC guarantees debt issued by the PPIF to the Participant Banks to finance the purchase of legacy loans, subject to debt-to-equity ratios determined by the FDIC (anticipated at ratios which will not exceed 6:1).

<u>Structure of Legacy Loan PPIFs</u>. These PPIFs will be formed by the FDIC.

Qualified Private Investors will be invited to make bids to purchase the private equity component of the PPIF's total capital structure. The sale of such equity stakes in the PPIFs to Private Investors will determine the total value of a specific Eligible Asset Pool.

Such PPIFs are subject to strict FDIC oversight. The FDIC will oversee the formation, funding and operation of the PPIFs. The FDIC and the Treasury will establish procedures governing the management, servicing, financial and operating reporting requirements, exit timing and alternatives for each of the Eligible Asset Pools. PPIFs must agree to waste, fraud and abuse protections provided by the Treasury and the FDIC for the protection of taxpayers. In addition, PPIFs must agree to provide access to information required by the Special Inspector General of the TARP, and the Government Accountability Office, the parameters of which remain to be spelled out. The Summary and FAQs are somewhat vague on how the PPIFs will be managed, other than to say, on the one hand, that PPIFs will be managed within parameters pre-established by the FDIC and the Treasury (with reporting to the FDIC and oversight by the FDIC; the FDIC having responsibility for providing information required by the Treasury), and, on the other, that the Treasury "will have no control rights."

<u>Legacy Loan Market Prices To Be Set by Private Investors at Auction</u>. It is anticipated that private investors in a PPIF will bid on pools of legacy loans in an auction conducted by the FDIC according to the following terms:

- *Eligible Asset Pools:* Eligible assets and any collateral supporting those assets must be situated predominantly in the United States. The FDIC will establish criteria to determine whether a Participating Bank's legacy loans are eligible to be auctioned under the PPIP program. The Summary does not specify whether all of the qualifying loans designated by a Participating Bank are deemed to be one Eligible Asset Pool, or whether the loans will be subdivided into multiple Eligible Asset Pools, each offered for bid on its own terms. The Summary also does not address whether the FDIC will pool loans issued by multiple banks. Participant Banks must demonstrate that the contemplated loan pools qualify based upon the criteria established by the FDIC and the Treasury.

- *Participant Banks Submit Legacy Assets to FDIC for Auction:* Participating banks, which must be "insured depository institutions" ("Participant Banks"), in consultation with their primary regulators, will determine which loans they wish to sell and notify the FDIC.

- *FDIC Evaluates Eligible Asset Pools:* The FDIC will conduct initial due diligence of the Eligible Asset Pools, as well as engage a third-party valuation firm to provide independent valuation advice with respect to each Eligible Asset Pool. The FDIC will determine the amount of funding it is willing to guarantee upon the completion of its due diligence. Leverage will not exceed a 6:1 debt-to-equity ratio.

- *FDIC Auctions Pools to Highest Bidder:* The FDIC will pre-qualify Potential Private Investors to participate in an Eligible Asset Pool auction. All bidders must submit a refundable cash deposit equal to 5% of the bid value. The purchase price determined at auction will be the amount used to determine the amounts of the Treasury investment and the FDIC guaranty.

<u>FDIC Financing Guaranty</u>. The consideration paid by the PPIF to the Participating Bank may be all cash or, more likely, a combination of cash and debt issued to the Participating Bank by the PPIF. A PPIF is authorized to issue non-recourse FDIC-guaranteed debt up to an amount determined by the FDIC on a case-by-case basis (but subject to a maximum debt to equity ratio of 6:1, or approximately 85%). The FDIC guarantee of such debt is to be secured by the Eligible Assets purchased by the PPIF.

Each PPIF must maintain a Debt Service Coverage Account ("DSCA") to ensure that its working capital is sufficient to meet its debt servicing obligations, interest expenses and operating expenses. The PPIF will retain a portion of cash proceeds from the sale of Eligible Asset Pools in escrow until the DSCA is fully funded, before any funds will be released to the holder of the debt portion of the purchase price (and, presumably, the PPIF itself after debt service).

<u>Treasury Provides 50% of Equity Capital</u>. The Treasury will fund 50% of the equity capital of each PPIF and will share in gains and losses with private investors in proportion to their equity interests (in other words, all distributions in respect of equity will be made *pari passu* to the private investors and the Treasury). Investors may seek to make an equity investment of more than 50% subject to the Treasury's approval and a minimum investment by the Treasury "to be determined." Alternatives for government capital may be adopted so long as such alternatives do not "diminish the collateral protection securing the FDIC guarantee" and are "capital-neutral" compared with the standard PPIF structure. The Treasury also will receive warrants issued by the PPIF as required by the Emergency Economic Stabilization Act of 2008.

<u>Assets Managed by Private Investment Managers</u>. Unless otherwise specified, loan servicing will be provided by the Participant Bank. Private investment managers will be retained to provide asset management services for the PPIF until final liquidation, subject to FDIC oversight (presumably, although not clear, this would include asset management for REO properties, it's unclear as to if and how advisory services will be obtained once a loan goes into default). The Summary does not indicate how such asset managers will be selected or whether such managers are appointed by the FDIC, the Treasury, private investors, or a combination thereof. Furthermore, the Summary leaves open how the management will be structured:

> "The FDIC and [the Treasury] shall establish governance procedures on the management, servicing agreement, financial and operating reporting requirements, exit timing and alternatives for each of the Eligible Asset Pools."

This suggests that each pool may have different management and operational structures. By contrast, under the Legacy Securities Program, investment managers submit an application to the Treasury to be considered for appointment as an investment manager of a fund.

Eligible Private Investors. Private investor groups must be approved by the FDIC and are expected to include financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds and pension funds, among others. 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.

Eligible Participant Banks. Eligible banks include any insured U.S. bank or U.S. savings association. Foreign institutions are not eligible. The Treasury and the FDIC will determine further eligibility criteria after consultation with the appropriate Federal banking agency.

FDIC Fees and Expenses. The PPIF will pay administrative fees to the FDIC for oversight functions and will reimburse the FDIC for all expenses related to conducting Eligible Asset Pool auctions. The FDIC will charge PPIFs an annual guarantee fee for the debt guarantee based on outstanding debt balances subject to the guaranty.

No Compensation Limits on Passive Investors. The program's Frequently Asked Questions provide that the executive compensation limits imposed by the Treasury will not apply to "passive" investors. It is unclear what is intended by the use of the word "passive" in this context. Compounding this are the lingering questions on the specifics for asset management of the PPIFs, since a private investor actively running the PPIF in question would arguably not be "passive" (and thus subject to executive compensation limits?).

FDIC To Finalize Details; Opportunity for Public Comment. FDIC Chairman Sheila C. Bair released a statement addressing PPIP in which she stated that the FDIC would immediately begin working to finalize the PPIP plan and promised the opportunity for public comment on critical aspects of the program prior to implementation.

Example of Hypothetical Investment under the Legacy Loans Program. The following example is excerpted from the Treasury's White Paper on the PPIP:

- *Step 1:* An FDIC-insured bank approaches the FDIC looking to divest a pool of residential mortgages.

- *Step 2:* The FDIC determines that the loans qualify for the program, and determines a valuation for the pool (assuming $100 as the value) and a debt-to-equity ratio of 6:1. The financing terms and such leverage ratio would be disclosed to the interested bidders as part of the auction process.

- *Step 3:* The FDIC forms a PPIF (while somewhat unclear as to who will form the PPIF, this appears to be what is intended) to acquire the assets and puts the entire pool up for auction. The highest bid received from private investors is $84 for the pool.

- *Step 4:* The FDIC guarantees $72 of the debt issued by the PPIF to the selling bank, based on the ratio determined in Step 2. The selling bank can later sell that debt.

- *Step 5:* The purchaser and the Treasury each contribute 50% of the equity funding required ($12) on a side-by-side basis, i.e., the Treasury and the private investor each invest $6. Note that it is unclear what role, if any, that the private investor would play in managing the assets.

The Legacy Securities Program

The Legacy Securities Program is designed to encourage and facilitate the purchase of legacy securities by providing both equity and debt financing to investors. The objectives of the program are to restart the market for legacy securities, enable banks and other financial institutions to extend new credit, and provide a means to determine a price for these illiquid securities. The program consists of two parts: 1) co-investments in Legacy Securities PPIFs formed to invest in asset-backed securities and 2) debt financing from the Federal Reserve under the Term Asset-Backed Securities Loan Facility ("TALF").

Unlike the Legacy Loan PPIP, the Legacy Securities Program will involve the selection of "up to five" private asset managers (see *Pre-Qualification of Fund Managers* below) which will act as the "Fund Managers" to implement and manage the investments, including the ability to control the selection and pricing of assets. These Fund Managers will be required to raise private capital to be co-invested with funds from the Treasury.

Legacy Securities PPIFs. The Treasury will establish up to five PPIFs that will invest in legacy securities including securities backed by mortgages on residential and commercial properties ("Eligible Assets"). Eligible Assets initially will include commercial mortgage-backed securities and residential mortgage-backed securities issued prior to 2009 that originally were rated AAA or an equivalent rating by two or more nationally recognized statistical rating organizations (without ratings enhancement) that are secured directly by the actual mortgage loans, leases or other assets. Such assets must be purchased from financial institutions from which the Secretary of the Treasury may purchase assets pursuant to Section 101(a)(1) of the Emergency Economic Stabilization Act of 2008. The Treasury will pre-qualify private asset managers ("Fund Managers") to raise equity capital from private investors for the PPIF. The Treasury will match private capital investments in the PPIF and share in any profits and losses with private investors on a *pari passu* basis.

- *Pre-Qualification of Fund Managers:* Fund Managers will be pre-qualified based upon:

    1. Demonstrated ability to raise at least $500 million of private capital;
    2. Demonstrated experience investing in Eligible Assets;
    3. Eligible Assets under management with a minimum market value of $10 billion;
    4. Demonstrated operational capacity to manage the Funds;
    5. Headquarters in the United States;
    6. Fees charged to private investors.

Applications must be received no later than April 10, 2009. The Treasury expects to inform applicants of its preliminary approval on or prior to May 1, 2009.

The Treasury currently plans to appoint five Fund Managers to raise private capital. Applicants will have a limited period of time after preliminary approval to raise at least $500 million of private capital before receiving final approval from the Treasury. The Treasury will consider other applications if they fail to do so. The Treasury expects to "define final terms and conditions for the Fund prior to fundraising."

- *PPIF Structure:* The private investors will invest in a vehicle controlled by the Fund Manager (a "Private Vehicle"). The Treasury will match the amount of equity financing raised by the Private Vehicle one-for-one on a fully side-by-side basis with these private investors. The Treasury expects Private Vehicles to be structured so that benefit plan investors (as defined under ERISA) will be eligible to invest in the Funds.

- *Tranche Equity Financing:* The PPIF will draw upon equity capital from the Treasury in tranches to provide for anticipated investments; provided that Treasury equity capital may only be drawn down at the same time and in the same proportion as private capital is drawn down. Debt financing will be funded concurrently with drawdowns of equity commitments. The Treasury reserves the right to cease funding of committed but undrawn equity capital and debt financing in its sole discretion.

- *Treasury Debt Financing:* The Treasury will provide additional financing to these funds in the form of senior debt in an amount up to 50% of total equity capital of the fund. Financing in excess of the 50% amount may be made available subject to further restrictions. The Treasury Debt Financing will be secured by the Eligible Assets held by the applicable Fund. Treasury Loans to any Fund will accrue interest at an annual rate and will be payable in full on the date of termination of the Treasury Capital Term. Treasury Debt Financing is not available to any Fund in which the private investors have voluntary withdrawal rights.

  The PPIF also may finance purchases through Legacy TALF, other Treasury programs and debt financing raised from private sources; provided that Treasury equity capital and Private Vehicle capital must be leveraged proportionately from such private debt financing sources.

- *Treasury Warrants:* The Treasury will receive warrants issued by the PPIF as required by the Emergency Economic Stabilization Act of 2008.

- *Asset Management:* The Fund Managers will make all decisions with respect to asset selection, pricing, asset liquidation, trading and disposition. The Funds will pursue a predominantly long-term buy-and-hold strategy over a term of a maximum of 10 years (although the Treasury will consider other strategies that "involve limited trading").

- *Eligible Assets:* Eligible Assets must be purchased from financial institutions from which the Secretary of the Treasury has the authority to purchase assets pursuant to § 101(a)(1) of the Emergency Economic Stabilization Act of 2008 ("EESA").

  Eligible Assets may only be purchased from sellers that are not affiliates of the Fund Managers or their respective affiliates or any private investor that has committed at least 10% of the aggregate private capital raised by such Fund Manager.

- *Fees:* Fund Managers may charge private investors fees in their discretion. The Treasury and the Fund Manager will negotiate fixed management fees to apply as a percentage of equity capital contributions for invested equity capital and payable solely out of distributions of Treasury equity capital.

- *Opt-out Right:* The Treasury retains the discretionary right to cease funding of committed but undrawn Treasury equity capital and debt financing.

- *Small, Veteran-Minority-and-Women-Owned Businesses:* To ensure a diversity of participation, the Treasury will encourage small, veteran-, minority- and women-owned private asset managers to partner with other private asset managers, if necessary, in order to meet the criteria identified above for assets under management and ability to raise private capital.

- *No Compensation Limits on Passive Investors:* The program's Frequently Asked Questions provide that the executive compensation limits imposed by the Treasury will not apply to "passive" investors.

<u>Example of Hypothetical Investment under the Legacy Securities Program</u>. The following example is excerpted from the Treasury's White Paper on the PPIP:

- *Step 1:* The 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 the 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. The 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. The Treasury also will 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, also would be eligible to take advantage of the expanded TALF program for legacy securities when it is launched.

<u>TALF Expanded To Include Legacy Securities</u>. To facilitate the foregoing Program, the Treasury and the Federal Reserve announced that the Federal Reserve will extend the TALF facility to fund purchases of legacy securities.

- *Eligible Collateral:* Eligible assets will include certain non-agency residential mortgage-backed securities that originally were rated AAA (without credit enhancement), as well as outstanding commercial mortgage-backed securities and asset-backed securities that are rated AAA.

- *Non-Recourse Loans:* As with other loans issued under TALF, the loans issued to fund the purchase of legacy securities will be non-recourse.
- *Eligibility Criteria To Be Determined:* The terms of TALF loans collateralized by legacy securities have not been determined. The Treasury and Federal Reserve will determine "haircuts," lending rates, minimum loan amounts, loan durations and other terms at a later date after consultation with market participants.
- *Coordination with Other Programs:* The Legacy Securities Program permits funds to access the TALF facility to purchase eligible mortgage-backed securities. To date, no details have been provided with respect to permitted leverage amounts and the eligibility criteria of each of the asset-backed securities and underlying collateral. Further information with respect to eligibility criteria and loan terms will be necessary to determine whether purchasers in the Legacy Loans Program can securitize the legacy loans and issue asset-backed securities to investors under TALF, as well as the merits of accessing the TALF facility to invest in the Legacy Securities Program.

Market Response Mixed

Response to the announcement of the PPIP has been mixed. On the day of the announcement, financial markets rallied and a number of well-known investment managers, such as Blackrock and PIMCO, announced their intention to participate. Other investors expressed reservations about partnering with regulators, especially in light of recent developments with AIG. These investors cited the risk of provoking punitive measures from Congress in the event profits exceed expectations, and, more generally, the fear that the government can unilaterally alter the terms of these programs during the term of the investments.

On March 19, the House of Representatives passed a 90% excise tax on bonuses paid to employees of AIG, an insurance company that has received approximately $170 billion in financial assistance from various government agencies. Congress took similar action in the 1980's with respect to its liquidation contracts with private firms following the collapse of the savings & loan markets.

Proskauer's Economic Crisis Response Group includes lawyers with extensive experience representing private and public companies, institutional investors, financial services companies, private equity and hedge funds, lenders, commercial banks and individuals in the complex and interrelated areas impacted by the current financial situation. Our multidisciplinary group brings together the talents of our business and transactional lawyers with our litigation capabilities, particularly as they pertain to acquiring, managing or disposing of distressed assets, issues concerning investments in financial services companies, complex financial instruments and transactions, including structured finance products, as well as a broad range of other areas such as corporate governance and defense, insurance coverage, reductions in force and other employment and benefit-related issues, securities regulation, and bankruptcy and restructuring matters.

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