SERT Update

United States Treasury Department Releases Details of the Public-Private Investment Program

On March 23, 2009, the United States Department of Treasury (Treasury) unveiled the long-awaited details of the Public-Private Partnership Investment Program (PPIP). Targeting illiquid real estate loans held on the books of financial institutions (Legacy Loans) and securities backed by loan portfolios (Legacy Securities), the PPIP is designed to open "lending channels by facilitating a market for distressed assets currently clogging the system."

The PPIP has been structured to combine $75 to $100 billion in capital from the Troubled Asset Relief Program[1] with capital from the private sector to generate $500 billion in purchasing power that will used to buy Legacy Loans and Legacy Securities.

The two prongs of the PPIP, the Legacy Loan Program and the Legacy Securities Program, are described in further detail below.

Legacy Loan Program

Under the new Legacy Loan Program, the Federal Deposit Insurance Corporation (FDIC) will provide oversight for the formation, funding and operation of new public-private investment funds (PPIF) that will purchase Legacy Loans. Equity in the PPIFs will come from private investors[2] such as financial institutions, individuals, mutual funds, publicly managed investment funds and pension funds. Private investors must be approved by the FDIC. In the Treasury's Legacy Loan Program Summary of Terms, dated March 23, 2009 (Legacy Loan Term Sheet), it is noted that, "Private Investors may not participate in any PPIF that purchases assets from sellers [of assets] that are affiliates of such investors or that represent 10% or more of the aggregate private capital in the PPIF."

Under the Legacy Loan Program, insured depository institutions (i.e., insured U.S. banks or U.S. savings associations) will decide which pools of loans[3] that they would like to sell. The FDIC will then conduct an analysis of each of the pools to determine the level of debt to be issued by the PPIF that the FDIC is willing to guarantee. Leverage will not exceed a 6:1 debt to equity ratio. Actual leverage ratios will be determined on a pool-by-pool basis by the FDIC, with input from a third party valuation firm. When assessing the supportable leverage of each asset pool, third party valuation firms will be asked to consider, among other factors, "expected cash flows based on type of interest rates, risk of underlying assets, expected lifetime losses, geographic exposures and maturity profiles."

[1] Further details of the Troubled Assets Relief Program may be found in this Firm's publication, dated October 8, 2008, entitled "Executive Summary of the Emergency Economic Stabilization Act of 2008." A copy of this publication can be found on our website, www.seyfarth.com, by clicking the SERT Alert/Strategic Economic Response Team icon.

[2] Executive compensation restrictions will not be imposed upon private investors as a result of their participation in the Legacy Loan Program.

[3] The loans comprising the pools must be "situated predominantly in the United States."

The FDIC will then conduct auctions for the sale of loan pools. Each bid submitted by a PPIF at the auctions will be accompanied by a refundable cash deposit equal to five percent of the bid value. After the conclusion of each auction, the seller (i.e., the lending institution) will then have a specified period of time to accept or reject the bids. If a PPIF's bid is accepted, the PPIF would have the option, subject to the maximum leverage ratios determined by the FDIC, of financing a substantial portion of the purchase price, apparently through debt financing provided by the seller of the assets.[4] For a fee, the FDIC will provide a guarantee of the PPIF's debt, collateralized by the assets being purchased by the PPIF. Further, the Treasury has committed to fund fifty percent (50%) of the equity requirement for the purchase. Accordingly, the equity requirement for the purchase would be divided evenly, 50%-50%, between the PPIF and the Treasury.[5]

The following example set forth in the Legacy Loan Term Sheet provides useful details as to how the Legacy Loan Program would work:

Sample Investment Under the Legacy Loan Program

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.

Private asset managers retained by the PPIFs will have control of asset management, subject to oversight by the FDIC. The Treasury and private investors will share in profits and losses in proportion to equity invested.

Legacy Securities Program

The new Legacy Securities Program has two key components: a new program that will involve an investment by the Treasury, side-by-side with private investors, and the expansion of the Term Asset-Backed Securities Loan Facility program (TALF Program).

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[4] In conjunction with the release of the Legacy Loan Term Sheet, the Treasury also released, on March 23, 2009, a "Frequently Asked Questions" sheet that provides that, "This debt [i.e., the PPIF's debt backed by the FDIC's guarantee] will initially be placed at the participant bank [i.e., the seller of the assets]. The participant banks will be able to resell this debt into the market if they choose."

[5] As noted in the Legacy Loan Term Sheet, alternatives to the 50% Treasury equity contribution may be adopted "so long as such alternatives do not diminish the collateral protection securing the FDIC guarantee and are capital neutral compared with currently contemplated investment."

New Side-by-Side Partnership Program

Under the new Legacy Securities Program, the Treasury will participate in Legacy Securities Public-Private Investment Funds (Funds). The Funds will be formed to invest in Legacy Securities. Per the terms set forth in the Treasury's Legacy Securities Public-Private Investment Funds Summary of Terms, dated March 23, 2009 (Legacy Securities Term Sheet), the Funds will purchase securities backed by "mortgages on residential and commercial properties issued prior to 2009 that were originally rated AAA or an equivalent rating by two or more nationally recognized statistical rating organizations without ratings enhancement" (collectively, "Eligible Assets"). The Eligible Assets must be secured directly by actual mortgage loans, leases or other assets and not other securities.

Per the Legacy Securities Term Sheet, the Funds will seek to "generate attractive returns for taxpayers and private investors through long-term opportunistic investments" by "following predominately a long-term buy and hold strategies involving limited trading." The term of the Funds shall be no greater than 10 years and it is anticipated that benefit plan investors, within the meaning of Section 3(42) of the United Stated Employee Retirement Income Security Act of 1974, as amended, will be eligible to participate as indirect investors in the Funds.

The Treasury is currently soliciting applications from private asset managers headquartered in the United States (Fund Managers) that, among other things, can demonstrate a capacity to raise at least $500 million of private capital, have had experience in investing in Eligible Assts and have a minimum of $10 billion (market value) of Eligible Assets under management. Applications must be submitted to the Treasury by April 10, 2009. The Treasury expects to approve approximately five Fund Managers and will consider expanding the program in the future. The Treasury anticipates issuing preliminary approval to the Fund Managers it selects on or prior to May 1, 2009.

Fund Managers will manage the Funds and have full control of asset selection, pricing, liquidation, trading and disposition. Fund Managers may charge private investors fees in their discretion, but fees proposed by Fund Managers will be considered by the Treasury when selecting Fund Managers. As noted in the Legacy Securities Term Sheet, "Each Fund Manager will be prohibited from purchasing Eligible Assets from sellers that are affiliates of such Fund Manager or their respective affiliates or any private investor that has committed at least 10% of the aggregate private capital raised by such Fund Manager."

After receiving preliminary approval, Fund Managers will have a limited period of time to raise at least $500 million of private capital before receiving final approval from Treasury. Once the Treasury issues final approval, Treasury funds will be invested into the Funds on a dollar-for-dollar basis with the private investors.[6] Further, each Fund Manager will have an option to obtain, for its Fund, secured non-recourse loans from the Treasury in an aggregate amount of up to 50% of a Fund's total equity (inclusive of the Treasury's equity). The Treasury will also consider requests for increasing such non-recourse financing to an aggregate amount of up to 100% of a Fund's total equity capital (inclusive of the Treasury's equity), subject to restrictions on asset level leverage, withdrawal rights, disposition priorities and other factors deemed relevant by the Treasury. All Treasury debt financing will accrue interest at an annual rate to be determined by the Treasury and will be secured by the Eligible Assets held by the Fund.

[6] Subject to a minimum to be determined, Funds will have the ability to accept less equity from the Treasury.

The following example set forth in the Legacy Securities Term Sheet provides useful details as to how the Legacy Loan Program would work:

Sample Investment Under the Legacy Securities Program

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.

Private investors will be prohibited from having voluntary withdrawal rights in the Funds prior to the third anniversary of the first investment by each Fund. Taxpayers and the Treasury shall share profits or losses on a pro rata basis in accordance with equity capital investments.

Expansion of TALF

Under the original TALF Program[7] that was announced November 25, 2008, the Federal Reserve Bank of New York (FRBNY) planned to make up to $200 billion of loans (TALF Loans) available to United States persons[8] that owned eligible collateral. The Treasury was to provide up to $20 billion of credit protection to the Federal Reserve in connection with the TALF Program.

In February, 2009, Treasury Secretary Geithner announced a plan to "build off, broaden and expand" the TALF Program by committing up to $1 trillion to support a "Consumer and Business Lending Initiative."[9] Secretary Geithner's plan was to

[7] Further details of the TALF Program may be found in the publication, dated December 9, 2008, entitled "The Creation of the TALF Program, the Citigroup Bailout and Other Recent Developments Related to the Emergency Economic Stabilization Act of 2008." A copy of this publication can be found on our website, www.seyfarth.com, by clicking the SERT Alert/Strategic Economic Response Team icon.

[8] A United States person is defined as a "natural person that is a U.S. citizen, a business entity that is organized under the laws of the United States or a political subdivision or territory thereof (including such an entity that has a non-United States parent company) or a U.S. branch or agency of a foreign bank."

[9] Further details of the Consumer and Business Lending Initiative may be found in the publication, dated February 11, 2009, entitled "Executive Summary: Treasury Secretary Timothy Geithner Announces a New "Financial Stability Plan"." A copy of this publication can be found on our website, www.seyfarth.com, by clicking the SERT Alert/Strategic Economic Response Team icon.

expand the TALF Program to include commercial mortgage-backed securities (CMBS) and use $100 billion to leverage $1 trillion in lending, although further details of the Consumer and Business Lending Initiative were not announced.

Under the TALF, the FRBNY offers a fixed amount of non-recourse loans each month. Such loans are awarded to borrowers through a competitive, sealed bid auction process. The minimum amount of each TALF Loan is $10 million and each of TALF Loans[10] must be fully secured by eligible collateral. Eligible collateral is defined under the TALF Program to include United States dollar-denominated cash asset backed securities (ABS) that have a long term credit rating in the highest investment-grade rating category from two or more nationally recognized statistical rating organizations and that do not have a long-term credit rating of below the highest investment-grate rating category from a major nationally recognized statistical rating organization.

Originally, the underlying credit exposures of eligible ABS had to be auto loans, student loans, credit card loans or small business loans guaranteed by the United States Small Business Administration. Now, under the "TALF for Legacy Securities Program," permitted underlying credit exposures will include, per the Treasury's March 23, 2009 press release, certain "non-agency residential mortgage backed securities that were originally rated AAA and outstanding CMBS that are rated AAA." Specific terms of this important new aspect of the TALF Program have not yet been formulated and, in fact, the Treasury's March 23, 2009 press release did not indicate whether new issuances of CBMS would qualify as eligible collateral under the newly expanded TALF Program. An announcement from the Treasury with details of the revised TALF Program will be announced after "discussions with market participants."

The TALF Program was officially launched on March 3, 2009. On March 19, 2009, the FRBNY announced that it had received bids for 4.7 billion in loans during its first subscription period.

It is anticipated that some of the borrowers under the expanded TALF Program may be newly formed trusts. Securities in these trusts would then be sold to investors. It is even possible that the securities in the trusts may become rated by credit ratings companies and possibly listed on certain stock exchanges. The use of such trusts would allow investors that otherwise do not qualify for TALF Loans to participate in the TALF Program in an indirect manner.

Conclusion

The Treasury has launched the PPIP, a program that it hopes will improve the health of the financial institutions, "leading to an increased flow of credit throughout the economy, and helping improve market functioning in the near-term." We will continue to keep you apprised as more details of the PPIP emerge and as its programs are implemented.

10 The amount of each of the TALF Loans is equal to the lesser of par or market value of the ABS less a haircut established by the FRBNY for each class of eligible collateral. Haircuts are determined based on the price volatility of each class of eligible collateral. Presently, TALF Loans have a three-year term, with interest payable monthly. Unless extended, TALF Loans will be made available to eligible borrowers until December 31, 2009.

For more information on the Public-Private Investment Program, please contact the Seyfarth attorney with whom you work, or one of our Strategic Economic Response Team (SERT) members below.

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