Treasury Announces Public-Private Investment Program

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The Public-Private Investment Program announced by the U.S. Treasury last week presents buy-side opportunities for investors as financial institutions transfer legacy loans and mortgage-backed securities from their books.

Designed to (i) use government financing and co-investment with the private sector to create substantial purchasing power, (ii) share risk and profits between the federal government (taxpayers) and private investors, and (iii) facilitate establishment of market pricing and, therefore, renewed transactions, the program contemplates the creation of public-private investment funds (PPIFs) to acquire the assets. The PPIFs will purchase legacy assets with a combination of secured non-recourse debt financing provided by Treasury, Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve, and equity capital provided by both Treasury and private investors.

This alert summarizes the key features of the program and highlights certain unresolved issues which will need to be addressed by Treasury, the FDIC and investors.

Legacy Loans

- Asset Class. Legacy loans are residential and commercial real estate loans and other assets approved for the program by the FDIC and held by FDIC-insured banks. The program guidelines do not currently specify any other criteria for legacy loans or what "other assets" can be included in the program.
- Private Investors. The program is intended to be available to a wide number of investors who will be pre-qualified by the FDIC, but no specific requirements have been specified in the recently released guidelines.
- Pricing; Bid Process. FDIC-conducted auctions will set a price for the legacy assets that may be accepted or rejected by the selling bank. Private investors wishing to make a bid will likely be required to demonstrate that they have sufficient private capital at such time and will be required to deposit five percent (5%) of the amount of each bid. In addition, private investors wishing to make joint bids will be required to do so prior to launch of the auction.
- Debt Financing. The FDIC will guarantee debt issued by the PPIF and held initially by the selling bank. The FDIC will set the leverage ratio, not to exceed 6 to 1, for each asset pool. The PPIF will be required to maintain a debt service coverage account, which will initially be funded through an escrow of a portion of the purchase price until such time as the legacy loans produce cash flow to fully fund the account.
- Equity Financing. Treasury will generally provide 50% of the equity capital necessary to purchase the legacy loans. The general terms of the equity investment for both private investors and Treasury have not been specified, except that Treasury will receive a warrant to purchase securities in the PPIF.
- Timing. The FDIC expects to seek public comment on the legacy loans program in the next few weeks.

Legacy Securities

- Asset Class. Legacy securities must be commercial or residential mortgage-backed securities that were issued prior to January 1, 2009, with a AAA rating obtained at the time of issuance from two nationally recognized statistical ratings organizations. The legacy securities must be backed by mortgage loans, leases or other assets and not other securities (other than certain swap positions, as determined by Treasury).
- Number of Investors. Legacy securities will be offered initially to five (5) PPIFs, which must be pre-qualified by Treasury. To be pre-qualified, a PPIF must be administered by a U.S. asset manager (Fund Manager) with the ability to raise up to $500 million of private capital and with a minimum of $10 billion of legacy securities under management.
- Debt Financing. Treasury will make available to the PPIFs debt financing equal to 50% of such fund's equity capital, which typically would equal the equity investment made by Treasury. Subject to conditions set by Treasury, the PPIF may also apply for additional debt financing from Treasury in an amount equal to the remaining 50% of the fund's total equity capital. Thus, for every private dollar invested, up to three dollars will be available through the federal government, in addition to any debt financing from the Federal Reserve via the Term Asset-Backed Securities Lending Facility (TALF)[1]

and Treasury for the purchase of securities. In any event, the Treasury Department will not provide any debt financing to any PPIF whose private investors have voluntary withdrawal rights. Finally, the Federal Reserve and Treasury will expand TALF to provide discounted debt financing to purchase legacy securities. Details of the expansion of TALF remain forthcoming, including whether such funding will be subject to the same leverage and withdrawal restrictions.

- Equity Financing. Treasury will provide 50% of the equity capital for the PPIF. Fund Managers may receive performance fees (i.e., carried interest), although such fees must be approved by Treasury. In addition, Treasury would also be entitled to receive warrants in the PPIF as required under the Emergency Economic and Stabilization Act (EESA).
- Pricing. Pricing decisions will be controlled by the Fund Managers. It is expected that having at least five Fund Managers will foster price discovery.

Key Issues and Unresolved Questions

Although the announcement provides some long-awaited details on the program, a significant number of details remain forthcoming, including the material economic terms and covenants for any debt financing. Market participants were pleased, however, to see that the term of the financing is longer than the original TALF program to accommodate the maturities of legacy assets. Various aspects of the program merit further attention as detail is provided, among them:

- Asset Class Remains Limited. The legacy loans program does not yet include bank-owned real estate (REO), but indications are that the program later may expand to include consumer debt, REO and other assets. The legacy securities program only applies to securities originally issued with a AAA rating. It is unclear what effect, if any, rating downgrades, subsequent to original issuance, will have on eligibility or whether the program will be expanded to include securities with lower ratings.
- Valuation Issues Will Continue. By introducing private money and competition (including an auction in the case of legacy loans), Treasury hopes to provide pricing guidance for the legacy assets; however, buyers and sellers with substantially different valuations may fail to reach agreement. Moreover, for selling banks that do not complete sales of their legacy loans, there is a question whether the auction provides a “data point” or an actual “mark” for accounting valuation purposes. Finally, the valuation process may also impact lending institutions which do not participate in the program, as appraisers may look to the auctions to consider the value of comparable assets. Recent developments and guidance on FASB 157 concerning mark-to-market accounting may also impact the level of selling.
- Auction Terms. The terms of the auction process, elements of bids, and size and composition of the pools remain to be fleshed out. Investors will want to know, for example, whether bids requiring less government equity and/or debt financing can enhance a lower bid or eliminate the requirement of debt service coverage accounts. FDIC has requested comment on this and other aspects of the program. The comment period ends April 10, 2009.
- Control Over Servicing Assets. The program term sheet provides that the selling bank initially will service the legacy loans assets, but the PPIF will retain control of servicing throughout operations, subject to relevant agreements. Asset managers will need to know what rights they have to replace the selling banks with a servicer they prefer (and control). Initial indications are that loans will be sold on a serving-released basis.
- Terms of Warrant Remain Open-Ended. The announcement provides that Treasury will receive warrants in the PPIF as required by EESA. Under EESA, Treasury has the right to receive warrants for stock or convertible senior debt in the institution from which it purchases troubled assets; however, Treasury now requires warrants from the PPIF buyer of these assets. The terms of the warrants have not yet been provided by Treasury, and thus the potential impact to the capital structure of PPIFs cannot be fully assessed at this time.
- Participation by Foreign-Owned Banks. FDIC is currently evaluating participation in the legacy loan program by foreign-owned banks.
- Executive Compensation Limits. Fees paid to Fund Managers by a PPIF will be subject to approval of Treasury. Treasury stated that passive investors in the PPIFs will not be subject to any executive compensation limits, but did not directly address Fund Managers or their principals in the PPIFs. Treasury FAQs indicate that compensation restrictions are targeted at executives of institutions receiving government support, and not TALF sponsors, borrowers or underwriters, so presumably Fund Managers are likewise excluded.

- PPIFs Will Be Subject to New Regulations. PPIFs will be subject to the oversight of Treasury and, in the case of legacy loans, the FDIC. PPIFs will be required to implement measures to prevent waste, fraud and abuse, and will be required to make their books and records available for inspection by the appropriate governmental regulators. Investors should be prepared to deal with a heightened regulatory oversight environment.
- Investors/Fund Managers Must Observe Conflict Rules. Private investors may not participate in any PPIF that purchases legacy loans from selling banks that are affiliates of such investor or that represent 10% or more of the aggregate private capital in the PPIF. Each Fund Manager may only purchase legacy securities from sellers that are not affiliates of such Fund Manager, any other 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.
- Fund Terms May Substantially Differ from Current Private Fund Terms. Key terms for PPIFs, especially for legacy loans, have not been defined; however, it is worth reviewing the terms that have been proposed by Treasury for legacy securities to gain an understanding of what Treasury expects to see in a PPIF. For example, Treasury will not pay any "incentive" or "carried interest" fees, although, subject to its approval, such fees may be paid by private investors. Treasury will pay a management fee equal to a portion of its capital, as well as fund expenses; however, such payments will only be made out of distributions, if any, received from the PPIF. Also, Treasury will propose limits on withdrawal rights, which may lockup investors longer than expected in other private investment funds and may limit the ability of PPIFs to attract pension fund investors. Finally, Treasury retains the right to withhold committed but undrawn capital in its sole discretion, resulting in the possibility that Treasury will not show up at a closing for the purchase of legacy assets.

We will continue to monitor program developments and provide updates as additional information becomes available. Beyond reporting emerging details, however, we recognize that the business community wants to know how to take advantage of these initiatives. At Andrews Kurth, our knowledge of the underlying asset classes and markets, our conversance with the capital-raising process and related formation and compliance issues, and our experience with pooled asset and public-private transactions make us ideally suited to assist our clients in capitalizing on these opportunities.

Additional information including term sheets, FAQs and related documents can be found at http://www.treas.gov/initiatives/eesa/. If you have any questions, or would like to discuss any of the foregoing in further detail, please feel free to contact Pat Sargent, Charlie Marshall or Peter McKee.

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[1] Under TALF, the Federal Reserve provides discounted financing, with credit support from Treasury, to purchasers of newly originated or recently issued asset-backed securities. In the first round of TALF, approximately $4.7 billion in newly issued auto and credit card ABS were financed.