Treasury's Public/Private Investment Program: What You Need To Know and Do Today

Yesterday the Department of the Treasury announced the establishment of the "Public/Private Investment Program" (the "Program") to purchase "legacy assets." As its name suggests, Treasury designed the Program to ensure that private companies share with the taxpayer a *pro rata* risk of gain or loss according to their investment. This newest Program is intended to complement the existing elements of Treasury's Financial Stability Plan (comprised of the Capital Assistance Program, the Homeowner Affordability and Stability Plan, and the Consumer and Business Lending Initiative), as well as related economic stabilization plans being operated by other federal agencies such as the FDIC and the Federal Reserve Board.

For purposes of the Program, "legacy assets" are comprised of "legacy loans" or "legacy securities." "Legacy loans" are real estate loans held directly on the books of banks and that otherwise meet criteria to be established by the FDIC. "Legacy securities" are commercial mortgage-backed securities ("CMBS") and residential mortgage-backed securities ("RBMS") issued prior to 2009 that were rated AAA by at least two nationally known rating agencies and that are secured by actual loans or leases (but not other securities). Public Private Investment Funds ("PPIFs") will invest in these legacy assets on behalf of Treasury and private investors under the auspices of the following two Program components:

- **Legacy Loan Program.** A program to support the purchase of troubled loans from depository institutions via support from the combination of the Federal Deposit Insurance Corporation ("FDIC") guarantee of debt financing with equity capital from the private sector.

- **Legacy Securities Program.** A program to address the problem of troubled securities via a combination of financing from the Federal Reserve Board (the "Board") and Treasury through the Term Asset Backed Securities Loan Facility ("TALF").

The Program will use $75 to $100 billion in TARP capital and capital from private investors to generate approximately $500 billion in purchasing power to buy these legacy assets.

Legacy Loan Program

Treasury anticipates that all manner of investors will participate in this program – including individuals, private equity funds, hedge funds, pension plans, insurance companies and any other long-term investors.

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The procedural process would be as follows:

1. **Identification of Loans.** A depository institution ("DI") of any size identifies to the FDIC the assets (i.e. pool of loans) that the DI wishes to sell.

2. **Determination of Eligibility.** The applicable banking regulator along with the FDIC and Treasury will determine whether the assets are available for purchase. Using contractors, the FDIC will analyze the pools, which may not have a debt-to-equity ratio in excess of 6-to-1, to determine the amount of funding it is willing to guarantee.

3. **Auction.** Once the assets are deemed eligible for purchase by a PPIF, and the FDIC has committed financing, the FDIC will auction the assets to qualified bidders.

4. **Bidding.** Private investors will bid for the opportunity to contribute 50 percent of the equity for the PPIF. Treasury will contribute the remainder. The FDIC will guarantee the debt.

   The DIs will make information available to the FDIC and private investors to facilitate the bidding process. A third party valuation firm selected by the FDIC will provide independent valuation advice to the FDIC on each asset pool. The valuation analysis will assist the FDIC in discussions with the DIs to determine the valuation of the asset and inform initial views on appropriate leverage and provide information about the structure and value of bids.

5. **Pricing.** The "price" for the asset to the selling DI is determined by the winning bid for the equity stake along with the amount of debt the FDIC is willing to guarantee. The DI must decide whether to accept this price. If the DI accepts the purchase price, the buyer will receive financing by issuing debt guaranteed by the FDIC. The FDIC-guaranteed debt would be collateralized by the purchased assets and the FDIC would receive a fee in return for its guarantee.

6. **Control and Management.** The private investor will control and manage the assets until final liquidation using asset managers approved by and subject to strict oversight by the FDIC and Treasury.

Legacy Securities Program

The Legacy Securities Program is divided into two parts – an expansion of TALF for legacy securities and the creation of legacy securities PPIFs.

Under the expanded TALF program, Treasury will make non-recourse loans available to investors to fund purchases of legacy securitized assets, including certain non-agency RMBA that were originally rated AAA and outstanding CMBS and Asset Backed Securities ("ABS") rated AAA. The types of haircuts, lending rates, minimum loan sizes and the actual duration of the loans are all details that have yet to be determined.

Under the legacy securities PPIF program, private investment managers will have the opportunity to apply for qualification as a fund manager. Treasury will approve approximately five fund managers who will be given a period of time to raise private capital to target the designated asset classes and will receive matching equity capital from Treasury.

Treasury funds will be invested dollar-for-dollar with those of investors. Fund managers will be fully responsible for asset selection, asset liquidation, trading and disposition. There are certain restrictions, however, with respect to the party from which assets may be purchased. For instance, fund managers may not purchase legacy securities from sellers that are affiliates of that fund manager or any other fund manager selected or their respective affiliates. Fund managers also may not purchase legacy securities from private investors who have committed at least 10 percent of the aggregate private capital raised by such managers. Information barriers must be sufficient to prevent investors from learning of potential acquisitions of specific legacy securities. Treasury may cease funding of committed but undrawn Treasury equity capital and debt financing in its sole discretion.

How Can Investment Managers Qualify as Fund Managers?

Treasury has published an application for private asset managers to apply to the Treasury to be pre-qualified to serve as a fund manager of a PPIF that will invest in legacy securities (http://www.treas.gov/press/releases/reports/legacy_securities_ppif_app.pdf). Fund managers will be pre-qualified based upon criteria that are anticipated to include:

- Demonstrated capacity to raise at least $500 million of private capital;
- The fees to be charged to private investors at the fund level;
- Demonstrated experience investing in legacy securities, including through performance track records;
- A minimum of $10 billion (market value) of legacy securities currently under management;
- Demonstrated operational capacity to manage the PPIFs in a manner consistent with Treasury's investment objectives while also protecting taxpayers;
- Headquartered in the United States; and
- Other criteria identified in the application.

Investments in PPIFs

In this rapidly evolving program, the exact structure of the PPIFs has not yet been set. Before bidding on assets, it will be critical to understand the structure of the PPIFs, any limitations that may exist with respect to the PPIFs, and to carefully consider the unintended consequences of partnering with a public entity. Venable lawyers involved in our public policy practice are working closely with our investment management lawyers to keep abreast of these changes as they develop.

Sales of Assets to PPIFs

DIs should quickly analyze whether to participate in the Program and, if they intend to participate in the Program, consider which assets would be eligible for sale. The process of identifying assets and understanding clearly which assets to include will require prompt, thorough attention.

What Depository Institutions Should Do Today:

1. **Understand Requirements.** Understand the eligibility requirement outlined in the two components of the Program; and

2. **Analyze Assets.** Undertake an analysis of which assets satisfy the Program consider whether selling those assets would strengthen or weaken the balance sheet. In that regard, DIs should fully understand the impact that sales of legacy assets will have on the DI's regulatory capital.

What Investors Should Do Today:

1. **Analyze Fund Structure.** Be prepared to analyze the fund structure proposed by Treasury in the PPIFs;

2. **Analyze Whether You Satisfy The Requirements To Run a PPIF.** Immediately consider whether to apply to serve in the role of a manager of one of the PPIFs, since applications are due to Treasury by 5:00 p.m. (ET) on April 10, 2009 for the Legacy Securities Program;

3. **Model Returns.** Model return profiles based upon reasonable market conditions now that the dollar-for-dollar match has been defined and the definition of eligible assets has been set; and

4. **Model Servicing.** Identify servicing requirements for any loan that may be purchased and document relationships with servicers and subservicers.

What Venable Can Do

While many of the terms have yet to be worked out, Treasury believes that the Program will generate significant private demand. The creation of PPIFs to liquidate legacy assets that are clogging the marketplace and prohibiting banks from returning to an acceptable level of lending is similar to the role the Resolution Trust Corporation played in the 1980's following a number of insolvency filings by savings and loan institutions. Treasury hopes that this Program will break the negative economic cycle that has developed where declining asset prices have triggered deleveraging that has in turn led to further price declines.

Venable's Financial Services, Legislative, Investment Management, Bankruptcy and Corporate Finance lawyers are working closely with clients that are interested in: (a) managing a PPIF; (b) purchasing an interest in a PPIF; (c) purchasing assets through TALF; and (d) selling eligible assets through the Program.

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