U.S. Public-Private Investment Program

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On March 23, 2009, the U.S. Department of Treasury ("**Treasury**") released much-anticipated details of its Public-Private Investment Program, aimed at improving the liquidity and pricing of troubled real estate loans and mortgage-backed securities.[1]

Two separate programs were unveiled, differing greatly in their timing, the assets targeted and the range of asset managers eligible to participate. Each of the programs relies on "public-private investment funds" ("**PPIFs**") to leverage private capital with substantial government contributions. In each of the programs the government will provide matching equity capital for the private investors, and either loans to the public-private vehicles or guarantees of their debt.

The **Legacy Securities Program** targets solely residential and commercial mortgage-backed securities, envisages about five asset managers, and seems to contemplate actual purchases occurring within 6-8 weeks.

The **Legacy Loans Program** aims at a much broader range of bank loans and securities, and envisions large numbers of private sector buyers for differing pools. As a result of program details and regulatory changes needed, the Legacy Loans Program seems unlikely to result in actual sales for a considerable period of time.

Today, the Federal Deposit Insurance Corporation ("**FDIC**") released additional program details for public comment, and hosted a call for banks to discuss questions about the Legacy Loans Program. We include information about the FDIC release and call where appropriate.

The salient features of the programs are summarized below. Note, however, that significant details of the programs are either unclear or yet to be announced; we discuss some of these missing details following the summaries.

[1] Additional information on the Public-Private Investment Program can be found at: http://financialstability.gov/

THE LEGACY SECURITIES PROGRAM

This program will use equity investments from the Treasury and private investors along with senior, non-recourse loans from Treasury, and potentially the Federal Reserve, to finance the purchase of legacy securitization assets by PPIFs.

- ***Treasury Investment.*** Treasury will match private investor equity on a 1-for-1 basis in each PPIF. In return, Treasury will receive warrants in the PPIF and its proportionate share of the profits. Treasury and private investors must invest in, and divest from, each PPIF proportionally, at the same time and on the same terms and conditions.

- ***Additional Treasury Financing; Private Financing.*** Treasury will make senior, non-recourse loans to the PPIFs for up to 50% of the total equity capital in each fund, and may consider requests for loans of up to 100% of the total equity capital raised. PPIFs may also obtain financing through other Treasury programs and from private sources, subject to the requirement that Treasury and private capital be leveraged proportionately if private debt financing is obtained.

- ***Eligible Program Assets.*** Eligible assets will include non-agency residential and commercial mortgage-backed securities originated before 2009 that were rated AAA or an equivalent rating at origination by two or more nationally recognized statistical ratings organizations and that are secured directly by mortgage loans, leases or other assets (but *not* other securities) situated predominantly in the United States.

- ***Eligible Sellers.*** Eligible sellers include not only banks and savings associations but also insurance companies and all other regulated financial institutions in the United States, including U.S. branches of non-U.S. banks.

- ***Fund Manager Selection and Fund Management.*** Treasury plans to select approximately 5 fund managers to manage the PPIFs, using a fast-track process with applications due by April 10 and manager selection expected by May 1. Fund managers will control the process of asset selection and pricing, and asset liquidation, trading and disposition, subject to reporting and audit requirements imposed by Treasury.

- ***Selection Criteria.*** Fund managers must have a minimum of $10 billion (market value) of eligible assets under management. In addition, fund managers must have a demonstrated track record of investments in the eligible assets, be headquartered in the United States and demonstrate a capacity to raise at least $500 million of private capital.

- ***Affiliate Limits.*** Fund managers are restricted from purchasing assets from sellers that are affiliates of the fund manager, any other fund manager in the program, their respective affiliates, or any private investor that has committed at least 10% of the aggregate private capital raised by the fund manager.

- ***Fees.*** Fund managers may charge fees to private investors, but fee proposals will be assessed as part of Treasury's evaluation of fund manager applications. In addition, Treasury will accept proposals for separate fixed management fees payable in respect of Treasury's equity capital.

- ***Expansion of the TALF.*** Through an expansion of the Term Asset-Backed Securities Loan Facility ("**TALF**"), non-recourse Federal Reserve loans will be made available to private investors to help finance purchases of non-agency residential mortgage-backed securities that were originally rated AAA, or commercial mortgage-backed securities and asset-backed securities that are rated AAA. Borrower eligibility criteria and the terms of the loans, such as interest rates, minimum loan sizes and duration of the loans have yet to be determined.

- ***Other Restrictions.*** Fund managers will be expected to comply with waste, fraud and abuse protections and to provide access to relevant books and records of the PPIF to Treasury, the Special Inspector General for the Troubled Assets Relief Program ("**TARP**") and the Government Accountability Office, and their respective advisors and representatives, to enable appropriate oversight and taxpayer protection.

THE LEGACY LOANS PROGRAM

This program will use equity investments from the Treasury and private investors along with FDIC guarantees of PPIF debt to finance, through numerous PPIFs, the purchase of troubled loans and other assets from insured U.S. banks or U.S. savings associations.

- ***Treasury Investment.*** Treasury is expected to match private investor equity up to a 1-for-1 basis in each PPIF. In return, Treasury will receive warrants in the PPIF and its proportionate share of the profits.

- ***FDIC Financing.*** The FDIC will guarantee (for an annual guarantee fee) debt issued by the PPIF to finance the remainder of the asset purchase, with a debt-to-total-equity leverage ratio of up to 6-to-1 (12-to-1 when considering only the private investors' equity component). The FDIC's guarantees will be non-recourse (secured only by the PPIF's assets).

- ***Investor Eligibility.*** Each private investor and group of private investors must be pre-qualified by the FDIC in order to participate in asset auctions. Apparently, all forms of equity investors, including financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds, pension funds, non-U.S. entities headquartered in the United States, private equity funds, and hedge funds, can participate, but no detailed eligibility criteria were released.

- ***Affiliate Limits.*** Private investors will not be permitted to participate in PPIFs that purchase assets from affiliates of those investors, or from sellers that represent 10 percent or more of the private capital in the PPIF.

- ***Eligible Sellers.*** Only insured U.S. banks and U.S. savings associations will be eligible to sell assets into the program. Banks and savings associations owned or controlled by non-U.S. banks or companies are not eligible.

- ***Identification of Assets for Sale.*** Eligible banks wishing to sell assets to PPIFs under the program are expected to work with their primary regulators to identify the asset pools they wish to sell, and thereafter approach the FDIC with their proposals. The proposal contemplates a collaborative process involving Treasury and FDIC to identify eligible asset pools. Assets will be eligible only if they (and any supporting collateral) are situated predominantly within the U.S.

- ***Auction Process.*** The FDIC will establish and oversee a complex auction process with the help of independent contractors and advisors. The FDIC and its advisors will engage in the initial due diligence and valuation of the assets offered for sale, and use their independent valuations to determine the appropriate leverage ratios for each auction. It is expected that FDIC will guarantee debt at no more than a 6-to-1 debt-to-equity ratio, but the leverage ratio for each auction will be independently determined. After the appropriate leverage ratio and other financing and auction terms are established, the FDIC will solicit bids from private investor groups.

- ***Winning Bids.*** The winning bidder in each auction will be selected by the FDIC based on investors' contributions of private equity. It will receive Treasury equity investments and FDIC debt guarantees to fully fund the PPIF. The selling bank will have the right to accept or reject the winning bid within a pre-determined time frame. If it accepts, the selling bank will receive consideration in the form of cash or cash and the FDIC-guaranteed debt issued by the PPIF, which it can hold or sell on the open market.

- ***Asset Management and Governance.*** Private fund managers will manage the assets for PPIFs under procedures to be established by Treasury and the FDIC and subject to FDIC oversight. The selling banks are generally expected to continue servicing the assets sold, though the PPIFs will have the right to make different arrangements.

- ***Other Restrictions.*** PPIFs will be expected to comply with waste, fraud and abuse protections; to make certain representations, warranties and covenants regarding their business operations; to provide information to the FDIC in performance of its oversight role; and to provide access to information for the Special Inspector General for the TARP and the Government Accountability Office.

- ***Expenses and Fees.*** In addition to the FDIC guarantee fee, PPIFs will be required to pay ongoing administrative fees for the FDIC's oversight functions, and the FDIC will be reimbursed for all expenses relating to the auction process.

- ***Launch Date.*** The detailed requirements of the program will be established by notice and comment rulemaking. The launch date will likely be considerably later than for the Legacy Securities Program.

INTERPRETIVE ISSUES

Several important features under the Legacy Securities and Legacy Loans Programs, summarized below, need to be clarified:

- ***Executive Compensation***. Will fund and asset managers be subject to executive compensation restrictions, on their incentive fees and any portion of equity participation they may have? What about investors who are deemed to have control? Treasury has made it clear that executive compensation restrictions will not apply to "passive" private investors, but it is otherwise unclear who will be subject to the restrictions. The incentive for managers to participate in these programs will clearly be reduced if managers are subjected to compensation restrictions. Will selling banks get comfort that they are not regarded as TARP beneficiaries by virtue of the TARP equity investments used to purchase their "legacy" assets?

- ***Treasury Involvement.*** Is Treasury's commitment firm enough? Will its right under the Legacy Securities Program to cease funding its committed but undrawn equity capital and debt financing, in its sole discretion, discourage the participation of fund managers? Will this absolute funding discretion functionally provide Treasury the ability to influence every decision the manager makes, by threat of withdrawal? Will Treasury be tempted to intervene under the Legacy Loans Program if it believes its equity contribution is at risk, given the somewhat undefined regulatory landscape in that program? Will it be difficult for managers to market these funds to investors who will be asked to irrevocably commit capital?

- ***Warrants.*** How will the warrants work? Will they dilute other investors? How will strike prices be determined, and when? Given the requirement under the EESA for

Treasury to be issued warrants in respect of the equity portion of their contribution to the PPIFs, how will PPIF interests be affected? Treasury has indicated that the terms and amounts of the warrants will be determined at a future date, in part based on the amount of Treasury financing. To what extent will Treasury have the ability to dilute the funds?

- ***Oversight and Political Risk.*** Can potential sellers, managers and investors become sufficiently comfortable with the risk of a change in law (or negative interpretation of law) in order to participate? Similarly, can participants become comfortable with the risk of adverse publicity given the virtual certainty of after-the-fact review by Congress and Inspectors General at a time when there may be claims of undue windfalls? It will be difficult for the administration to fully reassure participants that Congress will not interfere as public opinion and political dynamics shift. Will government policies, such as the new loan modification initiative, conflict with the interests of private investors?

- ***Regulatory Capital Considerations.*** The Legacy Loans Program requires selling banks to consult with their primary regulators when deciding what assets to sell. How will regulators' perceptions of necessary capital influence the decision of which assets to offer? What will be the impact of the new regulatory stress test? How much influence will regulators have over the business decisions of banks to either hold or sell assets at certain prices? Will the availability of extra capital under Treasury's Capital Assistance Program be used to induce banks to sell assets? The Legacy Loans Program explicitly requires selling banks to consult with their primary regulators, who would undoubtedly want to give input into decisions to sell under both programs.

- ***Treasury Capital: Management Fees, Expenses and Carry.*** Will managers have the ability to receive the types of incentive fees on Treasury capital they are typically accustomed to receiving? The Legacy Loans Program does not address incentive and management fees. Under the Legacy Securities Program, Treasury will pay fees and its share of expenses only out of distributions with respect to its capital. Does this effectively "back end" those payments? Will fund managers be doing extensive work and incurring extensive expenses before any distributions are made? Does this apply off the first dollar of any "distribution" or did Treasury more onerously mean to say "profits"? Will fund managers receive carry on Treasury's portion of equity capital?

- ***Valuations and Seller Loss Recognition.*** How will the problem of loss recognition be overcome so that financial institutions are willing to become sellers without risking their capital status? Will selling banks have to take the prices offered at a failed auction into account when valuing their assets, or can they use long-term fair value to disregard?

- ***Loan-level Information.*** The Legacy Loans Program provides that banks will make information available to private investors to facilitate the bidding process. How detailed will this information be required to be? Will the FDIC consider the views of private investors in deciding the scope and detail of required information?

- ***Complications in Forming Investor Groups.*** How difficult will it be to form and get pre-approval for investor groups? Will the difficulties of coordination among private investors faced with significant government oversight prevent a large pool of potential bidders from forming? Will there be restrictions on the terms of participation in investment groups (i.e., lock-up periods, withdrawal rights, etc.)?

- ***Retail Participation.*** What will Treasury do to encourage "retail" participation (as they apparently wish to do)? Will Treasury encourage fund managers to reduce fees for mutual funds or funds of funds that invest into the private funds, in order to minimize layering of fees?

- ***Transaction Fees.*** Will managers get a share of transaction fees, such as break-up and other deal fees received by the funds? The Legacy Securities Program suggests that any such fees received by the manager will accrue to Treasury and the fund's private investors.

- ***Lack of Withdrawal Rights.*** The Legacy Securities Program provides that no fund getting debt financing can give its investors voluntary withdrawal rights. Does this restriction also apply to transfers? Do private investors need to wait until the end of the term of the fund to liquidate their investment? Even for funds that do not receive financing, there is a minimum 3-year lock up for private investors. Among other things, this seems inconsistent with the goal of encouraging "retail" participation. Will the same restrictions apply under the Legacy Loans Program?

- ***Eligible Assets.*** The Legacy Loans Program is focused on legacy real estate loans, but leaves open the possibility that other loans and other asset types may be eligible. Will the inclusion of other asset types open new investment opportunities for investors and managers who are not eligible to participate in the Legacy Securities Program? Will eligible sellers be able to purchase assets from institutions that are not eligible to participate in the programs and sell such assets into the programs?

- ***Manager Qualifications.*** While the Legacy Securities Program is precise on the selection criteria for fund managers, what qualification requirements will be imposed on the private managers of assets owned by the PPIFs under the Legacy Loans

Program? What other restrictions might be placed on these managers (i.e., with respect to permissible fees and profit sharing)?

- ***Complexity.*** Given the particularized process under the Legacy Loans Program—with each proposed asset pool being examined by regulators and outside advisors, variable financing terms and debt leverage, and FDIC pre-approval of investors—will the process be too cumbersome to efficiently auction the assets of many banks?

FDIC COMMENT RELEASE

Today's comment release by the FDIC raised additional questions about the Legacy Loans Program. What will the level of government equity participation ultimately be? What impact will this have on private investment in the program? What will the parameters and rate structure of the FDIC-guaranteed debt be? Will PPIFs issue guaranteed notes directly to the selling banks, or will they sell the debt publicly and pay the banks in cash? How will the FDIC accommodate community and other small banks that may want to sell assets? Should the program permit multiple selling banks to pool assets for sale? What will the size and characteristics of each asset pool be, and how much will they vary? Will investors be required to bid on the entire equity stake of a PPIF, or can investors bid in partial stakes? How will the investor qualification requirements vary from auction to auction? Other than the government's loan modification program, what other constraints will be placed on asset managers?

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Structured Finance," "Banking and Financial Institutions," "Private Equity," "Mergers, Acquisitions and Joint Ventures," "Capital Markets" or "Employee Benefits" under the Practices section of our website at http://www.clearygottlieb.com.

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