Realizing the Goal of the TARP; Federal Government Announces Programs to Purchase “Toxic Assets”

Since the Emergency Economic Stabilization Act of 2008 (EESA), as amended, was signed into law almost six months ago, the federal government has rolled out program after program to help unlock the credit markets, stabilize the financial system with capital injections and provide much needed support to people who are in jeopardy of losing their homes. However, until yesterday’s announcement of the Public Private Investment Program (PPIP), the federal government had yet to address the problems of so-called “legacy assets” on the balance sheets of financial institutions, which are at the root of the current economic crisis and the underlying reason for the provision of the $700 billion Troubled Asset Relief Program (TARP) under EESA to purchase “toxic” mortgage-related assets.

This week's announcement from Treasury and the Federal Deposit Insurance Corporation (FDIC) of the launch of the PPIP, under the authority of TARP, was a crucial step to facilitate price discovery of these “legacy assets” and draw new private capital into the market, in an effort to improve the health of financial institutions currently burdened by legacy loans and securities. These “legacy assets” pose significant challenges by directly clogging the balance sheets of financial institutions, thereby compromising their ability to raise capital and increase lending in otherwise frozen markets. Furthermore, these “legacy assets” are difficult to value and present additional strain on a financial institution’s capital base, given the embedded “excessive discount” resulting from rapidly declining asset prices and lack of market liquidity.

A key component of the PPIP is the utilization of private capital and private fund managers to align public and private investor interests, in an attempt to limit taxpayer exposure and maximize the long-term value and potential upside for both taxpayers and private investors. The plan involves two main components:

- **Legacy Loans Program**—a program to purchase troubled “legacy” loans from insured depository institutions combining an FDIC guarantee of debt financing with equity capital from both private investors and Treasury.

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4. See Alston & Bird advisory, Loan Modifications; The Making Home Affordable Program [http://www.alston.com/files/Publication/3b1c6701-e734-4415-8b24-a66fa5ad8050/Presentation/PublicationAttachment/23b149e5-4b16-412b-89ec-a9572f605c79/Loan%20Modification%20Advisory%20(2).pdf](http://www.alston.com/files/Publication/3b1c6701-e734-4415-8b24-a66fa5ad8050/Presentation/PublicationAttachment/23b149e5-4b16-412b-89ec-a9572f605c79/Loan%20Modification%20Advisory%20(2).pdf)
• **Legacy Securities Program** – a program to purchase troubled “legacy” securities (initially those backed by mortgages on residential and commercial properties) combining financing from the Federal Reserve and Treasury through the Term Asset-Backed Securities Loan Facility (TALF) with equity capital from private investors and the Treasury.

Both programs will be initially funded with between $75 and $100 billion of TARP capital. Coupled with private investment and leverage financing from the FDIC and Federal Reserve, the PPIP is expected to generate $500 billion in purchasing power, with the potential to expand to $1 trillion over time. We describe the Legacy Loans Program and the Legacy Securities Program below, and raise several important issues that may arise from the implementation of both programs.

**Legacy Loans Program**

This program will attempt to reduce the “overhang of troubled legacy loans stuck on bank balance sheets,” by attracting private capital from investors to finance the purchase of eligible loan assets from participating banks through the provision of FDIC debt guarantees and Treasury equity co-investment. The FDIC will be seeking public comment concerning the Legacy Loans Program and expects to launch the program in the next few months. Below is a summary of how the program will work in its existing state:

**Asset Identification** – U.S. banks and savings associations (“Participant Banks”) wishing to participate in the program should begin to identify those assets, usually a pool of loans, they would like to sell into the program (“Eligible Assets”). Simultaneously, a Participant Bank should contact the FDIC to express interest in participating in the program, and also work with their primary bank regulator to both identify and evaluate such assets for eligibility. Eligibility will be determined based on Treasury and FDIC agreed upon minimum requirements. Other than the requirement that Eligible Assets and any collateral supporting those assets must be situated predominantly in the United States, no other specific requirements were disclosed as part of the Summary of Terms.

**Auctions** – Upon determination of an Eligible Asset for sale by a Participant Bank, the FDIC will conduct auctions for such Eligible Assets, to be bid on by pre-qualified private investors, including but not limited to other financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds and pension funds (“Private Investors”). Although a third party valuation firm will be retained to analyze the appropriate valuation of the Eligible Assets, inform the FDIC on initial views on appropriate leverage and provide information about the structure and value of bids, the FDIC will have sole discretion over review of received bids and the selection of the winning bids. Once a bid is selected, the Participant Bank will have the option of accepting or rejecting the bid within a pre-established timeframe. The winning bid will form the basis for the debt/equity ratio of the winning bidder’s public-private investment fund (PPIF).

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7 Banks or savings associations owned or controlled by a foreign bank or company are not eligible.
PPIF Financing/FDIC Guarantee – The purchase of the auctioned Eligible Assets will be funded through a combination of debt issued by the PPIF and equity capitalizing the PPIF. The debt will initially be placed at the Participant Bank, which may be subsequently sold into the market at the discretion of the Participant Bank. The FDIC will conduct an analysis to determine the amount of such debt it is willing to guarantee, provided that leverage will not, on a pool-by-pool basis, exceed a 6-to-1 debt-to-equity ratio. The FDIC-guaranteed debt would be collateralized by the purchased assets, and the FDIC would receive an annual fee, based on outstanding debt, in return for such guarantee. The remaining equity capital of each PPIF will be contributed 50 percent by each of Treasury and the Private Investors, and will be junior to the debt issued by the PPIF. Private Investors may take more or less equity in each PPIF (subject to a minimum government subscription right to be determined). From the investor’s standpoint, the “optimal” scenario would be one in which, combined with Treasury’s contribution and FDIC guarantees, the Private Investor is responsible for a maximum of seven percent of the purchase price of the assets. The PPIF will be required to maintain a Debt Service Coverage Account to ensure that working capital for each PPIF is sufficient to meet anticipated debt servicing obligations, interest expenses and operating expenses.

Governance/Management – Private fund managers will control and manage the assets of the PPIF until final liquidation, subject to strict FDIC oversight. Each PPIF must make certain representations, warranties and covenants regarding the conduct of their business and further agree to waste, fraud and abuse protections to be defined by Treasury and the FDIC. Private Investors may not participate in any PPIF that purchases assets from sellers that are affiliates of such investors, or that represent 10 percent or more of the aggregate private capital in the PPIF.

Warrants/Executive Compensation – Consistent with the requirements of Section 113(d) under EESA, as part of Treasury’s purchase of any “troubled asset,” Treasury shall receive warrants in the PPIF; however no specifics were provided in the Summary of Terms as to the amount or value of such warrants. The executive compensation restrictions outlined in Section 111 of EESA, as amended by the American Recovery and Reinvestment Act of 2009, will not apply to passive Private Investors (and to further entice private investment, it is possible that any additional legislation currently under debate in Congress, including the recent “bonus tax,” may not apply to passive Private Investors either).

Aside from the issue of whether the Legacy Loans Program will successfully help financial institutions purge themselves of troubled “legacy assets,” we have four key questions concerning the program in its existing state.

1.) How will the discretion by the FDIC in relying on third party valuation firms and selecting winning bids affect the price discovery function of the Legacy Loans Program? The apparent model for the auction process is the competitive bidding that the FDIC now undertakes for asset sales out of banks in receivership, and this process typically involves individual negotiations with bidders after the initial bids have been submitted. Because the FDIC has an economic interest in the Legacy Loans Program as a debt guarantor, and an interest in making sure both the Participant Banks and Private Investors end up on the right side of the investment, it may well be that the FDIC takes a more active role in facilitating pricing than a strict auction process would contemplate.

2.) What banks will be eligible for the Legacy Loans Program? The FDIC must manage two competing concerns in running the program. On the one hand, if the purpose of the program is to improve the
availability of credit, then the program should be limited to healthy banks that will have the ability to lend after the sale. Any asset sale is unlikely to immediately improve the financial condition of a troubled bank and thus will not enhance its lending ability. On the other hand, the FDIC retains its insurer interest in minimizing the resolution costs of troubled or failing banks. Asset sales through the Legacy Loans Program are likely to realize a somewhat higher price than asset sales through the receivership process, since the program gives the FDIC better negotiating leverage than does the receivership process. How the FDIC juggles these two concerns about troubled bank participation will affect the implementation of the Legacy Loans Program and may affect the overall success of the program.

3.) Will the recent outrage over executive bonuses and compensation structures dissuade Private Investors from participating in the Legacy Loans Program? While currently the compensation restrictions of EESA will not apply to passive Private Investors participating in the Program, the private investment community may nevertheless be reluctant to participate in the Program, given the fear that Congress may enact new or additional legislation ensnaring Private Investor participants in the Program.

4.) Are asset purchases under the Legacy Loans Program better or worse than purchases of similar assets out of a receivership? The Legacy Loans Program may present a kind of arbitrage opportunity for investors, at least with respect to certain assets. If an investor can qualify as a bidder on assets sold by the FDIC out of failed banks, then the investor can evaluate the cost of a purchase of eligible assets under the Legacy Loans Program, versus the cost of a purchase of comparable assets out of receivership. The FDIC often provides various kinds of loss-sharing and guarantees that are economically similar to the incentives under the Legacy Loans Program, and an investor may be able to make a judgment as to the more favorable pricing. In a perfect market, the prices should be the same. The FDIC may, however, have a stronger incentive as insurer to make receivership sales than to facilitate a comparable sale as guarantor. Of course, the scope of the Legacy Loans Program is likely to be far larger than the FDIC’s own sales of assets, so comparisons will not be possible in many cases.

**Legacy Securities Program**

This program will attempt to “address the broken markets for securities tied to residential and commercial real estate and consumer credit” and support the secondary market for mortgage- and asset-backed securities by expanding TALF and developing PPIFs to purchase legacy securities (securities issued prior to January 1, 2009).

**Expansion of TALF** – Treasury and the Federal Reserve will be expanding the category of eligible collateral for TALF to include legacy securities consisting of certain non-agency residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) that were originally rated AAA at issuance. As a result, private investors will be able to obtain non-recourse financing from the Federal Reserve (subject to a haircut) to purchase discounted securities meeting these and other TALF criteria. This expansion represents a significant departure for the TALF program, which currently includes as eligible collateral only newly issued,\(^9\) AAA-rated securities backed by auto loans, student loans, SBA-guaranteed loans, mortgage servicing advances, loans and leases of business equipment, leases of

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\(^9\) Issued on or after January 1, 2009.
vehicle fleets and auto and other floorplan loans. Treasury did not announce when the new categories of collateral would be included for TALF funding (the initial TALF funding is scheduled to close March 25, with subsequent funding to occur each month through 2009), nor did Treasury provide any information relating to haircut percentages for legacy securities. Details on the TALF expansion are fairly sparse, and it is possible that Treasury or the Federal Reserve may impose additional restrictions or criteria on eligible assets for the legacy securities portion of the program.

**Legacy Securities Investment Funds** – Treasury will be co-investing with private investors to create PPIFs to purchase legacy securities consisting of mortgage- and asset-backed securities that had AAA ratings at the time of issuance. Treasury will approve up to five (or possibly more, depending on the applications received) asset managers with “a demonstrated track record of purchasing legacy assets.” Each asset manager will form a PPIF and have a specified period of time in which to raise capital, which will be matched 1:1 by TARP funds from Treasury. The Treasury funds will be invested on a side-by-side basis with the private investors, ensuring that the investors and the government share equally in profits and losses. In addition, each PPIF will be eligible to borrow funds\(^{10}\) from Treasury in an amount up to 50 percent (and, in certain cases, 100 percent) of the total capital of the PPIF. Each PPIF will also be eligible to receive non-recourse financing from the Federal Reserve under TALF with respect to TALF-eligible legacy securities. Each fund manager will have full discretion of investment decisions for the PPIF; however, each fund manager will be encouraged (and selected on the basis of its intent) to follow a “long-term buy-and-hold strategy” for its PPIF.

The expansion of TALF and implementation of the PPIFs to purchase legacy securities may create sufficient incentive for private investors to enter the secondary markets for RMBS, CMBS and seasoned ABS, which have essentially halted since last fall. Certainly, the expansion of TALF expands on the current ability for investors to recognize low-risk returns based on the spread differential between their securities and related financing, by allowing investors to capitalize on discounts in the market as well. It is unclear, though, to what extent private investors will shy from business relationships with these government agencies in light of recent congressional responses to TARP recipients (as mentioned previously), which may be evidenced by the recent underwhelming subscription for the initial TALF funding.

However, while the PPIP creates incentives for private investment in legacy assets, and TALF includes financing for legacy securities and current (non-mortgage) asset-backed securities, the most obvious gap in all of these programs seems to be the continued absence of any program or incentive to increase current mortgage lending, a problem that still desperately needs to be addressed.

\(^{10}\) Funds borrowed from Treasury must be in the form of senior debt.
The following chart summarizes the highlights of the PPIP initiatives:

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<th>Legacy Loans Program</th>
<th>Legacy Securities Program (PPIF)</th>
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| **Capitalization**       | • 50-50 Private/Treasury in each PPIF  
• FDIC-guaranteed debt provided at 6:1 (debt: equity) ratio | • 50-50 Private/Treasury in each PPIF | • No restrictions (other than restrictions for PPIFs) |
| **Government Oversight** | • FDIC has principal oversight  
• FDIC to establish eligibility standards  
• FDIC will retain 3rd party valuation firm to analyze assets, bids and appropriate leverage | • Treasury selects investment managers for PPIFs  
• Treasury has oversight over PPIFs | • Federal Reserve determines criteria for TALF-eligible loans and retains oversight |
| **Management**           | • Private investors; no Treasury control  
• Oversight by FDIC | • PPIF managers have full discretion, but encouraged to maintain long-term buy-and-hold strategy | • No restrictions (other than restrictions for PPIFs) |
| **Eligible Sellers**     | • U.S. banks and thrifts  
• Specific eligibility likely to be decided by primary regulator  
• No foreign banks | • Anyone holding eligible legacy securities | • Anyone holding TALF-eligible legacy securities |
| **Eligible Private Investors** | • Meet FDIC criteria | • A “special vehicle” capitalized by private investors selected by the investment manager | • “Eligible borrowers” under TALF |
| **Eligible Assets**      | • To be determined by bank and its primary regulator  
• Assets must be “predominantly” located in US | • RMBS, CMBS and ABS that was rated AAA at issuance, in each case issued prior to January 1, 2009 | • RMBS, CMBS and ABS that was rated AAA at issuance, in each case issued prior to January 1, 2009 |
| **Form of Purchase**     | • Auction            | • Individually negotiated deals | • Individually negotiated purchases  
• Loans obtained through Primary Dealers |
| **Financing**            | • Debt issued to Participating Bank by PPIF  
• Debt guarantee from FDIC, up to 6:1 leverage, or about 84% of purchase price  
• Guarantee fee charged to PPIF | • Senior loans from Treasury up to 50% (in some cases up to 100%) of capital | • Non-recourse loans from Federal Reserve equal to purchase price of securities, minus applicable haircut percentage |
| **Economic Return**      | • Profits/losses shared equally between Treasury and private investors (collectively) | • Profits/losses shared equally between Treasury and private investors (collectively) | • Investors recognize any positive spread difference between securities rate and TALF loan rate, plus any increase in asset value  
• Investors bear economic risk only of haircut amount posted |

\(^{11}\) This column represents TALF-eligible financing only for legacy securities.
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