ARNOLD & PORTER LLP

CLIENT ADVISORY

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# TREASURY'S PUBLIC-PRIVATE INVESTMENT PROGRAM FOR LEGACY LOANS AND SECURITIES

As part of the Financial Stability Plan introduced on February 10, 2009, the US Department of the Treasury (Treasury)—in conjunction with the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve—announced on March 23, 2009 the details of its Public-Private Investment Program (PPIP). PPIP seeks to create multiple "Public-Private Investment Funds" (PPIFs) that will purchase from financial institutions certain legacy assets. By investing side-by-side with the private sector, Treasury hopes to encourage private investment while capturing the perceived associated pricing benefits resulting from competition among private investors.

Treasury has indicated that potential private-sector investors, such as financial institutions, individuals, mutual funds, pension plans, insurance companies, hedge funds, private equity funds, foreign investors (with US headquarters), and other long-term investors, will be able to maximize their investments in legacy assets through a government matching co-investment, while simultaneously benefitting from leverage offered by a combination of government funding sources, including FDIC debt guarantees, Treasury loans, and Federal Reserve lending authority. Treasury anticipates that the taxpayers will be protected from overpaying through PPIP's competitive pricing mechanisms. Treasury estimates that its use of between US$75 and US$100 billion of funds from the Troubled Asset Relief Program will generate up to US$500 billion in legacy asset purchases, with the potential to expand to US$1 trillion over time.

PPIP consists of two components that aim to address both legacy loans and legacy securities clogging bank balance sheets. The first program, the "Legacy Loans Program," combines FDIC debt guarantees with side-by-side Treasury and private equity investments to remove certain loans from bank balance sheets. The second program, the "Legacy Securities Program," joins private funds with loans from the Treasury and from the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) to purchase and hold troubled securities under the management of the private sector. Many important details of both the Legacy Loans Program and the Legacy Securities Program have not been determined yet, and the timeframe for implementation of the programs is uncertain. The basic details of these programs announced so far are discussed in this advisory.

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## LEGACY LOANS PROGRAM

Treasury has provided some details on the process that will be used to identify and purchase legacy loans from qualifying financial institutions pursuant to the Legacy Loans Program. US banks and US savings associations, except for those owned or controlled by a foreign bank or foreign company, are eligible to participate, with final eligibility determinations to be made by the FDIC and Treasury after consultation with the appropriate federal regulator.

The FDIC will bear responsibility for providing oversight for the formation, funding, and operation of the PPIFs that will be created to purchase assets under the Legacy Loans Program. In this role, the FDIC will establish guidelines as to which classes of loans and other assets will be eligible for sale. Pursuant to those guidelines and any additional guidance from Treasury or the primary banking regulators, eligible financial institutions[1] will identify assets to sell through the Legacy Loans Program and will notify the FDIC of their selection. The FDIC will analyze a financial institution's proposed pool of assets to determine whether it satisfies the FDIC's minimum requirements and to determine the level of debt the FDIC is willing to guarantee in connection with the sale of that asset pool. The maximum debt-to-equity ratio for any PPIF under the Legacy Loans Program will be six-to-one. The FDIC intends to use an independent third-party valuation firm to help it decide on the appropriate leverage for each pool.

Once the asset pools and leverage ratios are determined, the FDIC will conduct auctions for each pool of assets.[2] Potential private investors must be prequalified by the FDIC to participate in a particular asset pool auction. Multiple private investors may seek prequalification as a group. Once prequalified, the potential private investors will have access to a package of information about the pool so they can determine the amount they are willing to bid on the assets. Each bid must be accompanied by a refundable cash deposit of 5% of the bid value. The bank whose assets are being bid upon (Participant Bank) will have the option to accept or reject the winning bid. A private investor may not participate in any PPIF that purchases assets from sellers that are affiliates of the investor, among other related-party restrictions that presumably will be clarified by Treasury.

As consideration for its pool of assets, a Participant Bank will receive either cash or cash and debt issued by the PPIF. Such debt will be senior to the equity provided by the private investors and Treasury. The FDIC will guarantee the debt issued by a PPIF and charge an annual guarantee fee. The FDIC's guarantee will be secured by the assets purchased by the PPIF. Each PPIF will be required to maintain a Debt Service Coverage Account to ensure that the working capital for each PPIF is sufficient to meet anticipated debt servicing obligations. Servicing will be provided by the Participant Bank unless the PPIF selects a different servicer.

The Legacy Loan Program initially contemplates that private investors and Treasury will contribute equal amounts to the equity portion of a PPIF investment, as determined by the leverage ratio established by the FDIC. Private investors can choose to accept less Treasury equity subject to a minimum that has not yet been determined. The PPIF will issue warrants to Treasury consistent with the requirements of Section 113(d) of the Emergency Economic Stabilization Act (EESA).

The FDIC is seeking comments from the industry on certain details of the Legacy Loans Program, as it did with the Temporary Liquidity Guarantee Program. Comments can be submitted to LLPComments@fdic.gov. They are due by April 10, 2009. All comments will be made available to the public at http://www.fdic.gov/llp/index.html.

## LEGACY SECURITIES PROGRAM

The Legacy Securities Program will consist of two components designed to jump-start the market for mortgage-backed securities. The Federal Reserve will provide debt financing through TALF, while Treasury will match private capital raised in PPIFs that will invest in legacy securities and make additional leverage available through loans to PPIFs.

1 Banks and thrifts owned or controlled by a foreign bank or company are not eligible to sell assets under the Legacy Loans Program. Branches and agencies of foreign banks are also excluded.

2 The FDIC has requested comments on the type of auction process that would facilitate the broadest investor participation and the best mechanisms for such a process.

(1) TALF Expansion

Under the current TALF program, non-recourse loans are made to investors in asset-backed securities backed by certain types of business and consumer receivables. The Federal Reserve will expand the scope of this program as part of PPIP to provide loans for the purchase of certain non-agency residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) issued prior to 2009. These securities must have been rated AAA originally to be eligible for purchase in the expanded TALF program.

More details of the expansion are forthcoming, but Treasury has indicated that TALF for mortgage-backed securities will resemble the original TALF in that borrowers will need to fulfill eligibility requirements, and haircuts on the loan amount will be made relative to the riskiness of the collateral security asset. The remaining details of the program will be developed by the Federal Reserve after discussions with market participants.

(2) Legacy Investment Funds

Treasury will work with selected asset managers to co-invest in funds that will purchase eligible mortgage-backed securities issued prior to 2009.

(a) Qualified Fund Managers

The Treasury will select a group of asset managers to raise private funds to be matched one-for-one in Treasury equity investments. There will be approximately five managers selected, but Treasury may approve more or less than this target number. The prequalification standards are as follows:

- Capacity to raise at least US$500 million of private capital;
- Experience investing in mortgage-backed securities;
- A minimum of US$10 billion (market value) of eligible mortgage-backed securities under management;
- Operational capacity to manage funds according to Treasury's buy-and-hold investment objective; and
- Headquartered in the United States.

The fund managers that meet the prequalification criteria[3] must submit an application via email by April 24, 2009, a two-week extension of the original deadline. Treasury will inform applicants of their preliminary approval status around May 15, 2009. Preliminarily approved fund managers must then raise a minimum of US$500 million of private equity capital in order for Treasury to finalize the approval. In addition to large institutional investors, Treasury would like for fund managers to seek participation by retail investors. Benefit plan investors within the meaning of Section 3(42) of the Employee Retirement Income Security Act of 1974 may also participate as indirect investors. Treasury has indicated that passive investors within the fund will not be subject to special executive compensation restrictions.

(b) Treasury Equity and Debt Financing

After the fund manager raises the private capital, Treasury will match the funds on a one-for-one basis. The final terms and conditions of each fund will be determined prior to the private equity fundraising stage. In addition, Treasury will receive warrants in the fund pursuant to Section 113(d) of EESA.

The fund may obtain additional debt financing from both Treasury and the Federal Reserve. Treasury will grant fund managers the option to receive a non-recourse loan of up to 50% of the fund's total equity capital, secured by the assets purchased by the fund. Fund managers may also request debt financing for up to 100% of the fund's total equity subject to Treasury restrictions on the fund's asset level leverage, withdrawal rights, and other relevant factors. This additional financing is not available to funds in which the private investors have voluntary withdrawal rights. Fund managers may also seek TALF loans from the Federal Reserve (as discussed above) or private debt financing, subject to debt-to-equity leverage restrictions to be established by Treasury.

3 If a small or veteran-, minority-, or women-owned fund manager does not meet the prequalification criteria, it may partner with other fund managers in order to qualify.

(c) Fund Governance and Management

Qualified fund managers will have managerial control over the entire fund, including the capital provided by Treasury. They will control the process of asset selection, pricing, liquidation, trading, and disposition. Fund managers will also have discretion in setting private investors fees, subject to Treasury review during the application process. Treasury may also pay management fees to fund managers as a percentage of equity capital contributions raised.

The fund managers will need to fulfill a monthly reporting requirement detailing the assets purchased, the assets sold, and the current valuations of the fund. The asset prices used for these reports will be tracked through third-party sources, and a nationally recognized accounting firm will conduct an annual audit of the fund.

(d) Eligible Assets

The funds' purpose will be to purchase CMBS and RMBS issued prior to 2009 and to manage the assets under a long-term buy-and-hold strategy. The legacy assets must have been rated AAA or equivalent originally by two or more nationally recognized statistical rating organizations without ratings enhancement. The securities must be backed by actual loans or leases located predominantly in the United States. Eligible securities can only be purchased from financial institutions from which Treasury may purchase assets pursuant to Section 101(a)(1) of the EESA.[4]

(e) Fund Structure

Each fund manager will propose a structure for its individual fund to Treasury during the application process. The fund will last no longer than ten years, subject to a Treasury authorized extension. Although the general withdrawal rights of the private investors will be determined by the fund manager, no private investor may voluntarily withdraw from the fund prior to the third anniversary of the fund's first investment.

4 Pursuant to Section 3(5) of the EESA, this statutory limitation excludes "any central bank of, or institution owned by, a foreign government" within the definition of eligible financial institutions.

*We hope that you have found this client advisory useful. Arnold & Porter LLP attorneys can assist companies and financial institutions in working through the details of PPIP and determining whether and how to participate in the PPIP programs. We can also assist in preparation of responses to the FDIC's request for comments concerning the Legacy Loans Program. If you have additional questions regarding participation in PPIP, please contact your Arnold & Porter attorney or:*

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