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Cleaning Up the Toxic Mess – The Treasury's Emerging Plan to Promote Private Investment in Legacy Loans

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Introduction

On March 23, 2009, U.S. Treasury Secretary Timothy Geithner unveiled the Public-Private Investment Program (the "*PPIP*"), a program intended to invest $75 to $100 billion of funds from the Troubled Assets Relief Program ("*TARP*") to ease market pressure caused by concerns related to the toxic real estate loans currently held on bank balance sheets ("*Legacy Loans*") and securities that are backed by real estate loan portfolios ("*Legacy Securities*"). The U.S. Treasury (the "*Treasury*") and the Federal Deposit Insurance Corp. (the "*FDIC*") anticipate that the Legacy Loan Program portion of the PPIP (the "*Program*") will eliminate a significant number of such toxic assets from bank balance sheets. In comments made before the Council on Foreign Relations, Geithner indicated that the Treasury believes that the PPIP will generate an immediate $500 billion in purchasing power, and, over time, up to $1 trillion. The Program specifically targets commercial real estate loans, a sector previously largely ignored by the Treasury's economic relief efforts thus far. Since the Emergency Economic Stabilization Act of 2008 (the "*EES Act*") was signed into law in October 2008, TARP funds have not been applied directly to commercial real estate loans. In February 2009, the Treasury announced that the Term Asset-Backed Loan Facility would be expanded to include highly rated commercial mortgage-backed securities as collateral but no specific proposals were offered in connection with such expansion until the announcement of the Program. This article will focus specifically on the challenges presented by Legacy Loans and how such challenges are proposed to be dealt with by the Program.[1]

The housing bubble and its ensuing collapse caused banks and other investors to suffer significant losses. Distressed assets held on their balance sheets cannot be effectively priced, let alone divested. Approximately $525 billion of whole mortgage loans currently held by U.S. banks are expected to come due between this year and 2012 and approximately 50% of those loans will not qualify for refinancing, as they currently exceed a 90% leverage ratio.[2] Such assets have clogged balance sheets and are inhibiting lenders' ability to provide new financing. To successfully jumpstart new financings, these distressed assets must first be removed from bank

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balance sheets. Once the balance sheets are cleaned up, it is expected that lending institutions will have easier access to fresh capital and, having been relieved of the burden of their Legacy Loans, will be better situated to extend new loans and incur the associated levels of market risk inherent to the real estate lending business.

Overview of the Program

The Treasury has outlined the Legacy Loan Program in various documents, including a White Paper,[3] a Fact Sheet,[4] a Summary of Terms,[5] and a Frequently Asked Questions document.[6] Further, the Treasury has launched a public website providing information on certain aspects of the government's current economic stability efforts, which includes information on the Program.[7] So far, the Treasury and the FDIC have stressed in the applicable documentation and public commentary that the exact requirements and structure of the Program will be determined at a later date subject to the receipt and review of public comments. The broad parameters of the Program, however, are clear.

The Program will create Public-Private Investment Funds ("*Investment Funds*") comprised of equity joint ventures between the Treasury and private investors ("*Private Investors*"). The Investment Funds will then buy eligible Legacy Loans from participating lending institutions ("*Participating Banks*"). The contributions to the Investment Funds made by the Treasury will be funded with TARP funds.

The first step for Participating Banks will be to identify the distressed Legacy Loans they wish to sell into the Program. The FDIC will then review the designated assets or pools of assets, and determine the specific financing terms that will be made available for each asset or pool, as the case may be. An independent advisor will provide valuation advice to the FDIC in conducting its assessment.

The eligibility of assets to be sold into the Program will be determined collectively by the Participating Banks, their applicable regulators, the Treasury and the FDIC. Criteria will initially be determined by the FDIC, following which the Participating Banks will be required to demonstrate to the FDIC and the Treasury that their assets qualify under the established criteria. The Summary of Terms notes that the assets and any collateral supporting the assets must be primarily situated in the United States. No additional specific asset eligibility parameters are contained in the documentation released by the Treasury to date.

Once the assets to be sold have been qualified and the available financing terms established, the FDIC will auction off the asset pools to the highest bidder. The Treasury and the chosen bidder will form an Investment Fund to purchase the assets. The Investment Fund will then use FDIC-guaranteed debt to finance the purchase price. The FDIC will provide leverage of up to a 6.0:1.0 debt-to-equity ratio. The assets purchased will serve as collateral for the FDIC's guarantee. The amount by which the purchase price for the assets exceeds the FDIC financing amount will be funded by each of the Treasury and the Private Investor on a 50/50 basis. The Frequently Asked Questions document states that Private Investors will initially hold the debt and will be permitted to resell it into the market, but does not provide any particulars on how this process will work. Further, the Treasury will be granted warrants in each Investment Fund. At this point, the Treasury and the FDIC have not provided specific information regarding the terms of the warrants other than to state that they will be granted in accordance with the EES Act as a consequence of the funds contributed by the Treasury being TARP funds.

The range of Private Investors that the Treasury anticipates will participate in the Program include financial institutions, individuals, insurance companies, mutual funds, investment funds, pension funds, private equity funds, and hedge funds. The Treasury has especially encouraged participation by individual investors, pension plans, insurance companies and other long term investors. Participating Banks are required to be U.S. banks or savings associations and may not be owned or controlled by a foreign bank or company.

The FDIC's role in the Program will be multifaceted. It will oversee the formation of the Investment Funds and manage the funding and operation of those Investment Funds. The FDIC will also handle all aspects of the auctions. In its capacity as the manager of the Investment Funds, the FDIC will earn administration fees. Fees will also be paid to the FDIC as a consequence of its issuance of guarantees backing the debt issued by the Investment Funds to finance the Legacy Loan acquisitions.

Challenges and Questions

Given the many questions that remain unanswered concerning the Program and its implementation, the FDIC issued a request for public comments on March 26, 2009. The period for submitting such comments expired on April 10, 2009. All comments submitted by the public have been posted on the FDIC's website.[8] The Treasury and the FDIC are presently in the process of reviewing the public comments and had previously indicated that such comments were likely to influence the Program structure and requirements that are ultimately adopted.

The largest challenge facing the Program relates to pricing the distressed assets for sale. Until such assets can be effectively priced such that Participating Banks do not face significant losses simply by reason of selling assets into the Program, widespread participation in the auctions contemplated by the Program may be hindered. Further, once prices are established, it is possible that the establishment of such prices could in itself cause a further downward spiral in value of similarly situated distressed assets held by other financial institutions. It will be critical to differentiate in some manner the pricing of distressed assets sold into the Program from the pricing of other non-distressed assets that will remain on the balance sheets of Participating Banks, so as to avoid triggering additional write-downs across the financial industry.

Another uncertainty pertained to who would service the Legacy Loans once they have been purchased. The Treasury had noted in its White Paper that the assets are expected to be managed by the Private Investors using asset managers approved by the FDIC and subject to strict oversight by the FDIC. However, the Summary of Terms stated that servicing would in most cases be provided by the Participating Bank. The FDIC later clarified that it anticipated that the Participating Bank would act as the servicer for a limited period of time via a subservicing agreement with the Investment Fund, and that the servicing of the distressed assets would ultimately be transferred over to the Investment Fund. How these matters will be handled in practice remains to be seen.

The politically sensitive issue of compensation restrictions will pose another challenge to the Program. Potential participants have expressed concern about whether compensation restrictions would be applied. In light of recent public outrage relating to compensation at AIG, among others, the distinction between receiving bailout funds and investing money in the Program may not be evident to the public. To encourage participation from the private sector, the Treasury has stated that the Program will *not* be subject to the executive compensation rules that apply to other bailout programs. However, the Treasury's documentation on the Program notes that such restrictions will not apply to "passive" Private Investors without any further detail, leaving many wondering how "passive" they would need to be to avoid the compensation restrictions.

How the Program will be coordinated, if at all, with the Treasury's existing mortgage modification efforts under the EES Act remains to be seen. The EES Act requires the Treasury to both establish a mortgage modification program and to encourage mortgage modifications. Given that many of the Legacy Loans that would be purchased through the Program could be loans eligible for modification, there is valid concern that modification efforts could be hindered when financial institutions begin selling off the Legacy Loans. Commentators have suggested that the Program include an obligation on the part of the public/private Investment Funds to participate in any modification efforts in connection with the Legacy Loans they purchase. Those who oppose such a requirement argue that imposing such obligations will make Legacy Loans even harder to value and could discourage or prevent investors from participating in the Program.

The timing of the Program has also raised questions. Although the FDIC has indicated an intention to implement the Program as quickly as possible, the actual timeline that is followed will be affected by the extent to which changes to the Program are made in response to the public commentary received to date. Further, any complications arising in connection with the FDIC's review of the potential pools of Legacy Loans and other assets to be sold into the Program could cause additional delays.

Conclusion

The Legacy Loan Program is an ambitious undertaking that will require the cooperation of the U.S. Treasury, the FDIC, U.S. banks, the bank regulatory agencies, and private sector investors. Challenges abound. But if the Program succeeds, it may provide significant liquidity to the real estate financing market.

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Endnotes

1 The information in this Article is current as of April 22, 2009.

2 Lingling Wei, "Commercial Property Faces Crisis", The Wall Street Journal, March 26, 2009.

3 The White Paper can be found at: http://www.treas.gov/press/releases/reports/ppip_whitepaper_032309.pdf

4 The Fact Sheet can be found at: http://www.treas.gov/press/releases/reports/ppip_fact_sheet.pdf

5 The Summary of Terms can be found at: http://www.treas.gov/press/releases/reports/legacy_loans_terms.pdf

[6] The Frequently Asked Questions can be found at: http://www.treas.gov/press/releases/reports/legacy_loans_faqs.pdf

[7] The website can be found at: http://www.financialstability.gov/index.html

[8] The posted commentary can be found at: http://www.fdic.gov/llp/LLPcomments.html

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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