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Economic Growth and Development

RESTRUCTURING THE BANK BAILOUT

The Public Private Investment Program - "PPIP"

On March 23, 2009, U.S. Treasury Secretary Timothy Geithner announced details of a plan to stabilize banks by relieving their balance sheets of "toxic" or "troubled" assets. As a part of the Obama administration's "rebranding" campaign for these assets (formerly known as "toxic" or "troubled"), they have been renamed "legacy" assets.

This new program has been given the generic name of the "Public-Private Investment Program." (PPIP). The PPIP will include separate programs to purchase from banks, and other lending institutions, "legacy" real estate loans and "legacy" securities backed by real estate loans.

Essentially, the PPIP will be a highly leveraged program that involves private investment, up to $100 billion of TARP (Troubled Asset Relief Program) funds from the U.S. Treasury Department, Federal Reserve loans, and debt issued by private investors backed with guarantees from the Federal Deposit Insurance Corporation. The PPIP is designed to work with the other recently developed economic stimulus programs (such as TARP and the Term Asset-Based Securities Loan Facility), in a coordinated fashion, to restore stability and liquidity to the financial markets.

PPIP – For Legacy Real Estate Loans

One aspect of the PPIP will be the purchase of legacy real estate loans directly held by banks. As announced, the process will begin by banks identifying loans they wish to sell. It is anticipated that these loans will usually be pools of loans.

The FDIC will evaluate the loan pool and determine the amount of debt funding it is willing to guarantee for the purchase of the pooled loans. Leverage cannot exceed a six-to-one debt-to-equity ratio. The loan pools will then be sold to the highest private bidder in an auction managed by the FDIC.

The equity portion of the investment will be split equally in a joint venture between the winning private bidder and the Treasury TARP funds investment. The balance of the purchase price will be from debt issued by the winning private bidder and backed by a FDIC guarantee. The FDIC guaranteed debt will be collateralized by the purchased assets and the FDIC will receive a guarantee fee.

After the legacy loan pool has been sold to a PPIP created joint venture, private sector managers will be hired to control and manage the assets until they are finally liquidated under the oversight of the FDIC.

PPIP – For Legacy Securities

The PPIP process for purchasing legacy securities resembles the process for legacy loans, however, it is somewhat different. One difference is that this aspect of the program will be available to purchase legacy securities from various holders including banks, insurance companies, pension funds, mutual funds and others.

In the legacy securities program, the U.S. Treasury Department will pre-select the fund managers willing to purchase legacy securities through the program. Each fund manager will privately raise equity, that will be matched dollar-for-dollar by the Treasury. In addition, the Treasury may loan additional funds to the fund manager.

The manager of each new legacy securities purchase fund will also be able to take advantage of a proposed expansion of the Term Asset-Based Securities Loan Facility (TALF) program when it becomes available. It is currently thought that the TALF loans will be available to purchase certain residential mortgage securities, that were originally AAA rated, as well as outstanding commercial mortgage backed securities and asset-backed securities that are AAA rated.

Will The PPIP Be Successful?

Treasury Secretary Geithner is hopeful that the PPIP legacy asset programs will be successful. In no small part, these hopes are based upon the fact that the PPIP commitments have virtually exhausted the remaining TARP funds, and resistance to further bailouts is growing in Congress, as well as the general public. However, the initial burst of enthusiasm for the PPIP has been tempered by careful consideration of the various practical obstacles that must be overcome.

The fundamental issue that the PPIP legacy asset purchase programs must successfully address is establishing fair value prices for the legacy loans and securities that will attract willing sellers and willing buyers. Certainly, banks and other financial institutions who hold eligible legacy assets will need to feel comfortable that their sale of legacy assets, likely at lower than original cost, will not seriously jeopardize their capital structure and, in turn, their ability to remain solvent.

In the PPIP, Treasury Secretary Geithner does not appear to have created any strong incentives for the holders of legacy assets to be "willing-sellers." In fact, the only tools available to the regulators may be the use of the previously announced bank "stress tests" to require banks to become sellers. In other words, banks and other financial institutions may be required to participate in the PPIP by their regulators, as a condition of remaining "solvent."

This problem is exacerbated the current position of the Financial Accounting Standards Board ("FASB") that these legacy assets must be "marked to market" as described in FAS157. That accounting standard has been criticized and is currently under review by the FASB.

In fact, the FASB has issued draft proposed changes in FAS157 that may soften the impact of the application of this guidance in the current financial markets. At the present time, the FASB is accumulating comments on these proposals and expects to act on these issues at its April 2, 2009 meeting.

Under the current FAS157 guidance, the activities of the PIPP aimed at thawing the market for legacy assets is likely to have an impact upon all holders of legacy assets, whether or not they choose to be sellers in the PIPP. The reason is the new, likely lower, prices for these assets set in PIPP transactions will require a corresponding write-down of legacy assets that are still being held by banks and other financial institutions.

Ironically, this may be an incentive for holders of legacy assets to offer those legacy assets for sale, sooner rather than later. Otherwise, it is possible that the holders of legacy assets that elect to "hold," rather then to attempt to move them off their balance sheets, will be left holding the legacy assets and suffer from massive write-downs that quite likely will be caused by the new pricing for the legacy assets.

In contrast, Secretary Geithner's PPIP appears to have built in adequate financial rewards for potential purchasers of legacy assets. For example, private investors only need to: (i) provide no more than 50% of the equity capital; and (ii) non-recourse government loans will fund the balance of the purchase prices, up to six-to-one debt-to-equity ratio. Thus, the private investors in the PPIP legacy asset programs may enjoy potential windfall returns on their equity investments, with minimal downside investment risk. This aspect of the PPIP may create an active and competitive purchaser marketplace.

In fact, the biggest obstacle to attracting private purchasers to the PPIP will be concerns over the stability of the federal government's position on these legacy asset programs. Certainly, in light of the recent, after the fact, demonization of AIG executives over their bonus program, any private investor in these programs is likely to be concerned over whether there will be additional government imposed restrictions on executive compensation in the future.

Conclusion

In this second iteration of a financial institution bailout proposed by Secretary Geithner, the proposed relief is much more precisely targeted on the real problem than the relatively unfocused scope of the TARP last fall. However, the Achilles heel of the original TARP was overcoming the fundamental difficulty of finding willing buyers and willing sellers at a price reflecting fair value of the legacy assets. It remains to be seen whether the PPIP will be able to overcome that obstacle.

For additional information, contact:

C. David Paragas
dparagas@beneschlaw.com
614.223.9307

William Todd
wtodd@beneschlaw.com
614.223.9348

www.beneschlaw.com