



## U.S. Treasury 'White Paper' on Buying 'Legacy' Assets (Text)

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March 23 (Bloomberg) -- The following is a reformatted version of a "White Paper" released today by the U.S. Treasury about its Public Private Investment Program.

### Public-Private Investment Program \$500 Billion to \$1 Trillion Plan to Purchase Legacy Assets

Overview Troubled real estate-related assets, comprised of legacy loans and securities, are at the center of the problems currently impacting the U.S. financial system. The Financial Stability Plan, announced on February 10th, outlined a broad approach to address this issue via the formation of Public-Private Investment Funds ("PPIFs"). Today Treasury is announcing the Public-Private Investment Program under which it will make targeted investments in multiple PPIFs that will purchase legacy real estate-related assets. Addressing the problems created by legacy assets should help to improve the health of the financial institutions where they are held, leading to an increased flow of credit throughout the economy, and helping improve market functioning in the near-term. Investments made by Treasury under the Public-Private Investment Program are intended to complement the other components of the Financial Stability Plan that have been announced, including the Capital Assistance Program, the Homeowner Affordability and Stability Plan, and the Consumer and Business Lending Initiative, continuing the Obama Administration's efforts to improve the stability and functioning of the financial system.

The Legacy Asset Problem A variety of troubled legacy assets are currently congesting the U.S. financial system. An initial fundamental shock associated with the bursting of the housing bubble and deteriorating economic conditions generated losses for leveraged investors including banks. This shock was compounded by the fact that loan underwriting standards used by some originators had become far too lax and by the proliferation of structured credit products, some of which were illunderstood by some market participants. The resulting need to reduce risk triggered a wide-scale deleveraging in these markets and led to fire sales. As prices declined further, many traditional sources of capital exited these markets, causing declines in secondary market liquidity. As a result, we have been in a vicious cycle in which declining asset prices have triggered further deleveraging and reductions in market liquidity, which in turn have led to further price declines. While fundamentals have surely deteriorated over the past 18-24 months, there is evidence that current prices for some legacy assets embed substantial liquidity discounts. The discounts currently embedded in some legacy asset prices are a significant strain on the economic capital of U.S. financial institutions and have reduced their ability to engage in new credit formation. At the same time, the difficulty of obtaining private financing on reasonable terms to purchase these assets has limited the ability of investors to reduce these discounts. The lack of clarity about the value of these legacy assets has made it difficult for some financial institutions to raise new private capital. The Public-Private Investment Program is designed to draw new private capital into the market for these assets by providing government equity co-investment and attractive public financing. This program should facilitate price discovery and should help, over time, to reduce the

excessive liquidity discounts embedded in current legacy asset prices. This in turn should free up capital and allow U.S. financial institutions to engage in new credit formation. Furthermore, enhanced clarity about the value of legacy assets should increase investor confidence and enhance the ability of financial institutions to raise new capital from private investors. The primary areas of focus for the government's troubled legacy asset programs are the residential and commercial mortgage sectors, including both whole loans and securitizations backed by loan portfolios. These troubled assets are held by all types of

financial institutions, including those that predominantly hold them in the form of loans, such as banks, and those that predominantly hold securities, such as insurers, pension funds, mutual funds and individual retirement accounts. While the program may initially target real estate-related assets, it can evolve, based on market demand, to include other asset classes.

**The Public-Private Investment Plan: A Comprehensive Solution** A key principle of the chosen approach is to use private capital and private fund managers to help provide a market mechanism for valuing the troubled assets. By creating partnerships with private investors, this approach should serve to both protect the interests of taxpayers over the long-term and help restore liquidity and enable price discovery in the markets for troubled assets in the short-term.

The two key elements of the plan are: \* **Legacy Loans Program:** a program to combine an FDIC guarantee of debt financing with equity capital from the private sector and the Treasury to support the purchase of troubled loans from insured depository institutions. \* **Legacy Securities Program:** a program to combine financing from the Federal Reserve and Treasury through the Term Asset-Backed Securities Loan Facility ("TALF") with equity capital from the private sector and the Treasury to address the problem of troubled securities. The equity co-investment component of these programs has been designed to well align public and private investor interests in order to maximize the long-run value for U.S. taxpayers. Specifically, while the plan is designed to help reduce the liquidity discounts contained in legacy asset prices in the near-term, the most important way to protect taxpayers is to ensure that the government is not paying more for assets than their long-run value as determined by private investors. Since TARP funds will be invested alongside private capital on similar terms, this reduces the likelihood that taxpayers will be overpaying. At the same time, taxpayers will have the opportunity to participate in the asset's upside along with private investors. Similarly, the debt financing components of these programs have been structured to protect taxpayer dollars and the FDIC's Deposit Insurance Fund from credit losses to the greatest extent possible. Together, these two programs should help to restart markets for troubled assets, begin the process of repairing balance sheets, and eventually lead to increased lending in comparison with levels that would have occurred without this effort.

**The Legacy Loans Program** In order to help cleanse bank balance sheets of troubled legacy loans and reduce the overhang of uncertainty associated with these assets, the FDIC and Treasury are launching the Legacy Loans Program. This program will attract private capital to purchase eligible loan assets from participating banks through the provision of FDIC debt guarantees and Treasury equity coinvestment. A wide array of investors are expected to participate. The program will particularly encourage the participation of individuals, mutual funds, pension plans, insurance companies, and other long-term investors. The program is intended to boost private demand for distressed assets that are currently held by banks and facilitate market-priced sales of troubled assets. The FDIC will provide oversight for the formation, funding, and operation of a number of PPIFs that will purchase assets from banks. The Treasury and private investors will invest equity capital in Legacy Loans PPIFs and the FDIC will provide a guarantee for debt financing issued by the PPIFs to fund asset purchases. The FDIC's guarantee will be collateralized by the purchased assets and the FDIC will receive a fee in return for its guarantee. The Treasury will manage its investment on behalf of taxpayers to ensure the public interest is protected. The Treasury intends to provide 50% of the equity capital for each PPIF, but private investors will retain control of asset management, subject to rigorous oversight from the FDIC. Institutions of all sizes will be eligible to sell assets under the Legacy Loans Program. To start the process, banks will identify to the FDIC the assets, typically a pool of loans, that they wish to sell. Assets eligible for purchase will be determined by the participating banking organizations, including the primary banking regulators, the FDIC, and the Treasury. In order to protect taxpayer dollars from credit losses, the FDIC will employ contractors to analyze the pools and will determine the level of debt to be issued by the PPIF that it is willing to guarantee. This will not exceed a 6-to-1 debt-to-equity ratio. An eligible pool of loans, with committed financing, will then be auctioned by the FDIC to qualified bidders. Private investors will bid for the opportunity to contribute 50% of the equity for the PPIF with the Treasury contributing the remainder. The winning bid for this equity stake together with the amount of debt the FDIC is willing to guarantee (based on a predetermined debt-to-equity ratio), will define the price offered to the selling bank. The bank would then decide whether to accept the offer price. Once the initial transaction has

been completed, the private capital partners will control and manage the assets until final liquidation, subject to strict oversight from the FDIC. The FDIC will play an ongoing reporting, oversight and accounting role on behalf of the FDIC and Treasury. The exact requirements and structure of the Legacy Loans Program will be subject to notice and comment rulemaking.

**Example** If a bank has a pool of residential mortgages with \$100 face value that they are seeking to divest, the bank would approach the FDIC. The FDIC would determine, according to the above process, that they would be willing to leverage the pool at a 6- to-1 debt-to-equity ratio. The pool would then be auctioned by the FDIC, with several private buyers submitting bids. The highest bid from the private sector - in this example, \$84 - would define the total price paid by the private investors and the Treasury for the mortgages. Of this \$84 purchase price, the Treasury and the private investors would split the \$12 equity portion. The new PPIF would issue debt for the remaining \$72 of the price and the debt would be guaranteed by the FDIC. This guarantee would be secured by the purchased assets. The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis - using asset managers approved and subject to oversight by the FDIC. Through transactions like this, the Legacy Loans Program is designed to use private sector pricing to cleanse banks' balance sheets of troubled assets and create a more healthy banking system.

**The Legacy Securities Program** The Legacy Securities Program consists of two related parts. This program is designed to draw private capital into the markets for legacy securities by providing matching equity capital under the Treasury's Public-Private Investment Program and debt financing from the Federal Reserve and Treasury under the TALF. However, any private investor, even those who do not partner with Treasury under the Public-Private Investment Program, will also be able to access the TALF to purchase legacy securities. The goal is to restart the market for these legacy securities, which will allow banks and other financial institutions to free up economic capital and stimulate the extension of new credit. The resulting process of price discovery should also reduce the uncertainty surrounding financial institutions holding these securities, potentially enabling them to raise new private capital.

**Expansion of TALF for Legacy Securities** The Treasury and the Federal Reserve are creating a lending program that is targeted at the broken market for legacy securities tied to residential real estate, commercial real estate, and consumer credit. The intention is to incorporate this program into the previously announced TALF, which may total as much as \$1 trillion. Through this expansion of the TALF, non-recourse loans will be made available to investors to fund purchases of legacy securitization assets. Eligible assets are expected to include certain non-agency residential mortgage-backed securities ("RMBS") that were originally rated AAA, and outstanding and commercial mortgage-back securities ("CMBS") and ABS that are rated AAA. Borrowers will need to meet certain eligibility criteria. Haircuts will be determined at a later date and will reflect the riskiness of the assets provided as collateral. Lending rates, minimum loan sizes, and loan durations have not yet been determined. These and other terms of the program will be informed by discussions with market participants. As with securitizations backed by new originations of consumer and business credit already included in the TALF, the provision of leverage through this program should give investors greater confidence to purchase these assets, thus increasing market liquidity.

**Legacy Securities PPIFs** In conjunction with these efforts, the Treasury is also announcing a program to partner with private fund managers to support the market for legacy securities. Under this program, private investment managers will have the opportunity to apply for qualification as a Fund Manager ("FM"). Applicants will be pre-qualified based upon criteria that are expected to include a demonstrable historical track record in the targeted asset classes, a minimum amount of assets under management in the targeted asset classes, and detailed structural proposals for the proposed Legacy Securities PPIF. Treasury expects to approve approximately 5 FMs and may consider adding more depending on the quality of applications received. Approved FMs will have a period of time to raise private capital to target the designated asset classes and will receive matching equity capital from Treasury. FMs will be required to submit a fundraising plan to include retail investors, if possible. Treasury equity capital will be invested on a fully side-by-side basis with these private investors in each PPIF. Furthermore, FMs will have the ability, to the extent their fund structures meet certain guidelines, to subscribe to Treasury for

senior debt for the PPIFs in the amount of up to 50% of a fund's total equity capital, and Treasury will consider requests for senior debt for the PPIFs in the amount of up to 100% of a fund's total equity capital subject to further restrictions on asset level leverage, redemption rights, disposition priorities, and other factors Treasury deems relevant. This senior debt will have the same duration as the underlying fund and will be repaid on a pro-rata basis as principal repayments or disposition proceeds are realized by the PPIF. These senior loans will be structurally subordinated to any financing extended by the Federal Reserve to these PPIFs via the TALF. Treasury expects the PPIFs to initially target non-agency RMBS and CMBS originated prior to 2009 with a rating of "AAA" at origination.

Example Treasury will launch the application process for managers interested in the Legacy Securities Program. An interested FM would submit an application and be pre-qualified to raise private capital to participate in joint investment programs with Treasury. Treasury would agree to provide a one-for-one equity match for every dollar of private capital that the FM raises and provide fund-level leverage for the proposed PPIF. The FM would commence the sales process for the PPIF and raise \$100 of private capital for the PPIF. Treasury would provide \$100 of equity capital to be invested on side-by-side basis with private capital and would provide up to a \$100 loan to the PPIF if the fund met certain guidelines. Treasury would also consider requests from the FM for an additional loan of up to \$100 subject to further restrictions. As a result, the FM would have \$300 (or, in some cases, up to \$400) in total capital and would commence a purchase program for targeted securities. The FM would have full discretion in investment decisions, although the PPIFs will predominately follow a long-term buy and hold strategy. Depending on the amount of loans provided directly from Treasury, the PPIF would also be eligible to take advantage of the expanded TALF program for legacy securities when that program is operational.

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