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Is Half a PPIP Better than None?

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After months of preparation, the Treasury has finally announced its program for dealing with so-called legacy assets on the books of the nation's banks. However, the program as announced addresses only a narrow class of troubled securities.

The revised plan does not cover troubled whole loans and banks holding these assets will get no immediate benefit from the plan. Originally, PPIP was supposed to cover both toxic securities and toxic loans, but potential purchasers of whole loans balked at the potential risks, including political risks, and decided that as proposed that portion of the PPIP was not worth it.

The revised program also does not cover all types of troubled securities, or even all types of troubled asset-backed securities. Only mortgage-backed securities in a class that was originally rated AAA are included. Omitted are securities backed by other types of indebtedness, such as auto loans and credit card loans. Also omitted are classes of securities issued in mortgage securitizations that were originally rated below AAA.

Purpose

The revised PPIP plan has as its stated goal to "support market functioning and facilitate price discovery in the asset-backed securities markets." Given that these markets continue to be frozen because of price disparity between what potential purchasers are willing to bid and the price that sellers are willing to accept, the latest proposal offers the hope that with Treasury capital and financing, private equity will find the leverage attractive enough to warrant higher bid prices.

Proposed Structure

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The proposed structure contemplates the formation of a series of funds, each to be managed by a sponsor chosen by the Treasury. The Treasury has chosen nine well-known asset managers to form the funds and manage the acquisition and disposition of the legacy securities. Each manager will invest $20 million of its own capital in the fund it will sponsor and has indicated an intention to raise at least $500 million of capital from private sources for the fund, with the Treasury matching that dollar for dollar. Once up and running, each fund is expected to begin purchasing legacy securities utilizing a combination of debt financing up to the amount of the total equity of the fund, with additional leverage available through the existing Term Asset-Backed Securities Loan Facility.

Eligible Assets are limited to commercial mortgage-backed securities and nonagency residential mortgage-backed securities issued prior to 2009 that were originally rated AAA or the equivalent, 90% of which are U.S. assets. Selling institutions are contemplated to be U.S. financial institutions, not foreign government agencies.

The Term Sheet accompanying the Treasury's announcement also covers matters such as the diversification and investment limitations of each fund, restriction on the fund sponsors, permitted distributions and expenses, exclusivity and avoidance of potential conflicts.

Whether this newest plan achieves its stated goal remains to be seen. Some of the concerns earlier expressed remain. The Government will have the right to audit the books and records of the funds and those affiliated with it. On the other hand, the Treasury has announced that the executive compensation limitations of existing legislation will not apply to investors in the funds as long as the funds are structured "such that asset managers themselves and their employees are not employees of or controlling investors in the funds." Passive investors will not be subject to these restrictions.

The political dimension to this revised plan remains. The Treasury wants the private market to become significant players in this version of PPIP. Private players have to be convinced that by participating they will not become scapegoats because government funding will enable them to make a profit. The possibility of some type of "after the fact" criticism or limitations about the potential profitability of this plan for the private sector is still worrisome to many.

Loss of PPIP for Whole Loans

If it was not already clear from the comments of the FDIC last month, a PPIP for purchases of whole loans is no longer on the drawing board. In the latest Treasury announcement, the Treasury made mention of a possible future expansion of the program to whole loans later in the year, but only for loans that would be sold by the FDIC from the receiverships of failed banks. No details of the timing, scope or nature of even that program were provided. For now, there seems at most to be a possibility that the FDIC would be the sole seller into any such program that may eventually be created. That would not, of course, serve the purported goal of the PPIP to assist operating banks in cleansing their balance sheets of toxic assets.

Exclusion of Non-Mortgage Securities

The securities that may be sold to a Fund under the PPIP are limited to commercial and nonagency residential mortgage-backed securities. This was anticipated in the Treasury's earlier announcements. The latest announcement does not hint at any future expansion to other types of asset-backed securities. Thus securities backed by pools of auto loans, credit card loans and other consumer and business receivables are excluded. Also, mortgage securities that are backed by Fannie Mae and Freddie Mac are excluded.

Mortgage-backed securities are far and away the largest category of legacy asset-backed securities, so it is neither surprising nor troubling that this would be the first sector that the Treasury Department has tackled. Moreover, it is heartening that commercial mortgage-backeds are included in this first effort, as that may be the most interesting part of the market for investors.

Exclusion of Lower-Rated Tranches

Although equally expected, the limitation of the program to securities that were originally rated AAA is unfortunate. It means that the most "toxic" securities will not be affected. They cannot be sold through the program, and the process of price discovery will not be advanced for them. Historically, the securities tranches that were originally rated AAA were typically designed for sale to pension funds and other institutional investors, not banks. An exception was agency securities, which often were created by banks for the purpose of retaining the investment risk, but achieving a more favorable treatment for regulatory capital purposes. But agency securities have been excluded from the PPIP.

The financial firms that have applied for, and have now been granted, the right to form a Fund under the PPIP undoubtedly have their sights on particular assets that meet the requirements in the new Treasury announcement. Given the time that has elapsed, there may well be specific transactions that have been discussed and can be closed in the required time frame. If, however, only the senior tranches of MBS deals are susceptible of purchase, the program will not serve as a vehicle for taking control of underlying loan pools. Moreover, the quantity of eligible securities, and the financial institutions whose balance sheets might be aided by the program, will be relatively circumscribed.

Possible Arbitrage

One possible avenue for expansion would be if banks were to buy qualifying securities from the pension plans, private investors and others that now hold them. If the program takes off, it is certainly conceivable that financial institutions that qualify to sell to PPIP Funds will seize upon this as an arbitrage opportunity. If that materializes, the PPIP could serve to aid balance sheet management not only for banks but also for other holders of the formerly AAA paper. If that would happen, the size of the affected market could be enormous.

Modification of Underlying Loans

A PPIP Fund that purchases residential mortgage-backed securities will be required to consent to "reasonable" requests from servicers and trustees for approval to participate in the Treasury's Making Home Affordable Program, or for approval to implement other "reasonable" loss mitigation measures (including term extensions, rate reductions, principal write-downs or removal of caps on the percentage of loans that may be modified within the securitization structure). Perhaps this requirement holds the key to an unstated goal of the Treasury. The goal of cleansing the balance sheets of banks was less prominent than was the promise of moving securities into the hands of owners who would take a lenient view toward loan modification. If that is the goal, then the prospect of banks acting to arbitrage sales of such securities currently held by pension funds and other nonbank investors becomes a significant benefit. Even in the absence of a governmental mandate to consent to loan modifications, a private investor is likely to have greater flexibility than a pension plan, which is beholden to its beneficiaries, or a public corporation beholden to stockholders.

Unfortunately, the limitation of PPIP investments to formerly AAA-rated securities remains an impediment. It would be unusual for a securitization to grant control over loan modification decisions to the senior class alone. Either that power is vested in the servicer, or it is shared with other classes, requiring consent from multiple classes of certificateholders. If the junior classes were all held privately, then obtaining consent from all classes might be accomplished. More typically, if a AAA-rated class was sold publicly, there would also have been at least one other class distributed in a public offering. It remains to be seen, therefore, whether loan modifications prove to be promoted to any significant extent by reason of this feature of the PPIP.

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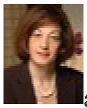

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