INTRODUCING THE LEGACY LOANS PROGRAM - THE GOVERNMENT'S LATEST ATTEMPT TO ADDRESS THE CURRENT CREDIT CRISIS

On March 23, 2009, the Treasury formally announced the latest government program aimed at restoring stability to the financial system. The new Public-Private Investment Program (PPIP) is touted by the Treasury as another critical piece of the government's plan to get the credit markets flowing again and banks to resume lending to households and businesses. One portion of the PPIP [1] the "Legacy Loans Program", endeavors to use a combination of government and private funds to raise capital to purchase, and thus a create a market which currently does not exist for, "legacy loans" which have continued to plague the financial system in the form of "toxic" real-estate related loans clogging the balance sheet of banks. Of interest to both banks looking to shed bad loans and investors alike, the following is a brief look at the Legacy Loans Program.

The Players.

- The "public" component of the Legacy Loans Program involves a coordinated effort between the Treasury and the Federal Deposit Insurance Corporation (FDIC). The FDIC will oversee the formation, funding and operation of the individual public-private investment funds (PPIFs) that will be created to own and manage each pool of assets to be sold. In addition, the FDIC will guarantee the debt issued by PPIFs to acquire the assets, as described in further detail below. The Treasury will provide equity financing for the acquisitions, and will oversee and manage such equity contributions. The Treasury's initial commitment to the program is projected to be $75 billion to $100 billion from funds budgeted under the Troubled Asset Relief Program (TARP).
- The "private" component of the Legacy Loans Program is expected to be comprised of financial institutions, individuals, insurance companies, mutual funds, pension plans, private-equity funds and hedge funds. Private investors must be pre-qualified by the FDIC, under criteria that has yet to be announced. Joint bids from pre-qualified private investor groups will be allowed, but only prior to the beginning of an auction.[2] In addition, "private investors may not participate in any PPIF that purchases assets from sellers that are affiliates of such investors or that represent 10% or more of the aggregate private capital in the PPIF."[3]
- Eligible banks that wish to participate in the Legacy Loans Program include any insured U.S. bank or savings association, meaning any "bank or savings association organized under the laws of the United States, any State of the United States, the District of Columbia, any territory or possession of the United States, Puerto Rico, Northern Mariana Islands, Guam, American Samoa or the Virgin Islands."[4] Banks owned or controlled by a foreign entity are not eligible.

The Process.

- Participating banks will designate pools of assets they wish to dispose. Eligible assets include "loans and other assets from depository institutions under criteria established by the FDIC,"[5] and eligibility will be determined by the banks, their primary regulators, the FDIC and the Treasury. In addition, the eligible assets (and any collateral supporting those assets) must be located predominantly in the United States. Once an eligible pool of assets is determined, the proposed terms of the financing and the leverage ratios (not to exceed 6 to 1) for each PPIF, as determined by the FDIC on an individual case-by-case basis, will be provided to potential investors prior to submission of auction bids. Each asset pool will then be auctioned off by the FDIC to private investor purchasers. A cash deposit equaling 5% of the value of the bid must accompany each bid, and will be refunded if the bid is unsuccessful or eventually rejected by the participating bank.
- If the highest bid is accepted within a pre-established timeframe, financing for each pool will be comprised of equity and debt financing. The latter will be in the form of debt guarantees provided by the FDIC on debt issued by the PPIF of up to six dollars for each dollar invested by the Treasury and private investors. The collateral for the FDIC's debt guarantee will be the purchased assets, and the FDIC would also receive an annual debt guarantee fee based on a to be determined percentage of outstanding debt balances. The equity contribution depends on the amount of the leverage guaranteed by the FDIC, with the Treasury providing up to 50% of the balance of the purchase price in the form of equity, i.e., net of the debt guaranteed

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by the FDIC. The private investor would contribute the balance. While it is contemplated that private investors can opt to take less than 50%, the Treasury will have a minimum subscription right that has yet to be determined.

- Private fund asset managers approved and subject to oversight by the FDIC will have management rights and control over the PPIFs, including disposition and final liquidation of the assets. However, the FDIC will have strict oversight over the PPIFs and governance procedures for the PPIFs will be established by the FDIC and the Treasury. Servicing will generally be provided by the participating bank.

UNCERTAINTIES AND OPPORTUNITIES.

- At this stage, there are still certain unknowns. While the Legacy Loans Program is structured to have the market determine the price of assets, it remains to be seen whether banks and investors will be able to reach an acceptable price and whether the spread between the asking price and the bids will be bridged. Also, the terms of the debt financing to be guaranteed by the FDIC are not fully delineated, including the interest rate and length of the financing term. In addition, the PPIP is subject to notice and comment rulemaking, so the exact terms and conditions have not been determined. Such rulemaking will also take some time, notwithstanding that the FDIC hopes to commence the Legacy Loans Program and close its first auction as soon as possible.
- The Legacy Loans Program does have the potential to markedly alter conditions for distressed loan pool sales. This is because it creates leveraged returns for investors, through the use of high loan-to-purchase price debt at a relatively low cost. Such a structure materially increases the likelihood that asset sales which promise high returns to investors can be achieved without placing intolerable price pressure on sellers. The Legacy Loans Program should present attractive opportunities for banks looking to cleanse their balance sheets by unloading bad loans and who, heretofore, have been unwilling to sell their loans to all cash buyers requiring 25 to 30% unleveraged returns on their investment. Further, leverage created from the debt guarantees by the FDIC of up to six dollars for each dollar invested by the Treasury and private investors creates additional purchasing power.
- If the length of the term of the financing to be guaranteed by the FDIC is shorter than the realistic holding period required to liquidate the financed assets in the ordinary course, the financing component will create a material risk of loss of investment to the PPIP investors. A forced sale of the financed asset due to maturity of the financing will be problematic because such financing is likely to be impossible to replicate. A positive aspect of the financing is that if the value of the assets declines, the private investors' losses will be limited to their equity investment, and they can walk away from the issued debt guaranteed by the FDIC.
- The existence of this program may have little effect on the market for asset sales conducted outside the program, or on asset sales by non-bank institutions ineligible to act as program sellers. Sales of such ineligible assets and sales by ineligible sellers may continue to experience relatively wide bid/ask spreads and limited transactional activity, with sellers reluctant to sell at relatively depressed prices to all cash bidders.
- The feature of the Legacy Loans Program that calls for the selling banks generally to service the loans following sale may have an adverse impact on the willingness of investors to purchase assets, or at least types of assets for which strong servicing skills are viewed as important. The typical profile of a distressed asset purchaser is that of a liquidator and loan enforcer, often intent on extracting the maximum amount of cash from the purchased asset in the shortest time achievable. Typically, such purchasers retain highly experienced asset managers to implement this process. A selling bank may, on the other hand, be much more interested in maintaining its customer relationships on a friendly basis, rather than seeking to maximize returns on the sold asset through aggressive collection efforts. Thus, in addition to other underwriting considerations, asset purchasers will need to take into account the loan servicing capabilities and collection mentality of the selling bank. It remains to be seen whether servicing standards will be established that require selling banks to employ a servicing standard beyond the manner in which they would customarily treat their own assets. On the other hand, the retained servicing feature may encourage selling banks to participate in the program who would not otherwise be inclined to turn their customers over to aggressive loan purchasers.
- In addition, while a private investor may be subject to limits on executive compensation as a beneficiary of TARP funds, investment in a PPIF would not impose any such executive compensation limits so as to not deter investor participation.

[1] *Please note that this client alert does not cover the other portion of the PPIP, the "Legacy Securities Program", devoted to liquidating secondary market securities backed by loan portfolios.*

[2] *The auction process is described below.*

[3] *http://www.treas.gov/press/releases/reports/legacy_loans_terms.pdf*

[4] *http://www.treas.gov/press/releases/reports/legacy_loans_terms.pdf*

[5] *http://www.treas.gov/press/releases/reports/legacy_loans_faqs.pdf*

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