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Client Alert

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TREASURY PUBLIC-PRIVATE INVESTMENT PROGRAM PRESENTS OPPORTUNITIES AND UNANSWERED QUESTIONS

Monday's announcement by the Treasury Department of the launch of the Public-Private Investment Program ("PPIP") offers prospective investors and fund and asset managers the opportunity to take advantage of government financing to acquire troubled and illiquid loans and certain asset-backed securities. It offers depository institutions the opportunity to sell these loans and securities, ideally at a more favorable price than is available in today's market.

The details of the PPIP are still being developed, but the most up to date information available can be found at <http://financialstability.gov>. In brief, however, the PPIP consists of two distinct parts: a Legacy Securities Program and a Legacy Loan Program.

Legacy Securities Program

The Legacy Securities Program contemplates equal side-by-side equity investments by the Treasury and by private investors investing through a private vehicle (a "Private Vehicle") in a public-private investment fund (a "Securities PPIF"). Treasury is also entitled to receive warrants issued by the Securities PPIF. The Securities PPIF will in turn acquire securities that:

- (i) are backed by residential and commercial mortgages "situated predominantly in the United States,"
- (ii) were issued before January 1, 2009,
- (iii) were rated (without ratings enhancement) the equivalent of AAA by two or more nationally recognized statistical rating agencies when issued, and
- (iv) are purchased from a financial institution as defined in the Emergency Economic Stabilization Act of 2008, including a U.S. commercial bank, investment bank and insurance company, and a U.S. branch or subsidiary of a foreign bank, but not a U.S. bank "owned by" a foreign government.

The Securities PPIF will be eligible for a senior secured non-recourse loan from Treasury in an amount of up to the total equity contributed by the government and the private investors. It will be able to borrow in the private markets secured by the Securities PPIF's eligible assets but will also be eligible to use the securities as collateral to borrow from the Federal Reserve Bank of New York under the Term Asset-Backed Loan Facility ("TALF") at a yet-to-be-determined rate, maturity and haircut.

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The Securities PPIF is to be managed by a pre-qualified fund manager which will also manage the Private Vehicle. Applications from fund managers must be filed by April 10, 2009. To pre-qualify, an asset manager, among other things, should have its headquarters in the United States, have \$10 billion in eligible securities under management and be able to demonstrate experience and competence in fundraising and managing eligible securities. Treasury expects to inform applicants of their preliminary approval by May 1, 2009, at which point an applicant must demonstrate the ability to raise at least \$500 million before receiving final approval.

Securities PPIFs will be subject to “final terms and conditions” to be announced by Treasury before fundraising begins. The term of a Securities PPIF will be limited to 10 years (unless extended by Treasury), at which time any financing provided by Treasury will be repayable in full.

Treasury retains the right in its sole discretion to terminate its unfunded commitments to a Securities PPIF for debt or equity at any time.

Legacy Loan Program

The Legacy Loan Program also contemplates side-by-side equity investments by Treasury and by private investors in a public-private investment fund (a “Loan PPIF”). Unlike in the case of the legacy securities program, the Treasury may contribute less (but no more) than 50 percent of the total equity. Treasury will receive warrants issued by the Loan PPIF. Eligible private investors must be pre-approved by the FDIC and may include “foreign investors with a headquarters in the United States.” The Loan PPIF in turn will acquire pools of loans that:

- (i) are “located predominately in the United States,”
- (ii) are purchased from a U.S. bank or savings association that is not owned or controlled by a non-U.S. bank, company or government,
- (iii) are identified by the selling depository institution in consultation with its primary federal regulator, and
- (iv) satisfy certain yet-to-be-announced “minimum requirements” agreed on by the FDIC and Treasury.

The Loan PPIF will issue FDIC-guaranteed debt to the selling depository institution, which in turn may resell the debt into the market. The amount of debt that the FDIC will guarantee will be determined by the FDIC based on a third-party appraisal of the pool of loans to be acquired by the Loan PPIF and a debt-to-equity ratio (not to exceed 6-to-1) determined by the FDIC based on the characteristics of the pool. The FDIC will conduct an auction sale of the pool, review the bids and select the winning bid.

Asset managers approved by and under the “strict oversight of” the FDIC will manage the Loan PPIF under governance procedures yet-to-be-established by the FDIC and Treasury. The selling institution will continue to service the loans.

Open Issues

1. Executive compensation. Each PPIF is likely to be considered a “TARP recipient” and therefore subject to the executive compensation restrictions of the American Recovery and Reinvestment Act. Less clear is whether fund and asset managers, selling depository institutions (that redeem or have not already received any TARP capital) or private investors will be subject to these restrictions, although government officials’ statements since the announcement suggest they will not be.
2. Oversight of PPIF Managers. The Legacy Securities Program does not appear to contemplate oversight or regulation by the government of the managers of Securities PPIFs once they are pre-qualified except that (i) both programs are subject to as-yet-undefined “waste, fraud and abuse” protections, and (ii) Securities PPIF managers must provide access to their books and records. By contrast, an asset manager of a Loan PPIF is to be subject to the “strict oversight” of the FDIC, including FDIC-imposed policies regarding loan modifications. Residential real estate loans that are subject to the Making Home Affordable Program and that are sold to a Loan PPIF will undoubtedly still be subject to the provisions of that program.

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3. Buy-and-Hold Strategy. A fund manager of a Securities PPIF will “control” trading in the assets of the PPIF but must pursue an investment strategy “that is predominantly a long-term buy-and-hold strategy.” It is unclear what this restriction will mean, whether it will permit, for example, hedging and how it will be enforced.
 4. Foreign Private Investors. The FDIC will need to clarify what is meant by eligible foreign investors “with a headquarters in the United States.” It may be sufficient that a foreign investor simply have an office in the United States that it considers “a” U.S. headquarters.
 5. Treasury Warrants. Treasury appears to have had no choice under the statutory language but to require the PPIFs as recipients of TARP funds to issue warrants to it. How these warrants will affect the capital structure of the funds and the rights of investors remains to be worked out.
 6. Withdrawal Rights of Investors. Whether and when a private investor may withdraw funds from a PPIF is unclear. On the one hand, Treasury will not lend to a Securities PPIF unless investors are prohibited from exercising withdrawal rights. On the other, an investor may, subject to as-yet-undetermined limitations, have withdrawal rights at the Private Vehicle level after an initial three-year lock-up period. No restrictions appear to be imposed on withdrawals from a Loan PPIF.
 7. Fees and Expenses. No details are available about the amount of various fees that will be charged by the government and how management fees will rank relative to claims by Treasury and the FDIC. Fees under the Legacy Loan Program include a guarantee fee to be paid to the FDIC for its guarantee of debt issued by the Loan PPIF and an administrative fee to be paid to the FDIC for oversight functions. The FDIC is also to be reimbursed for its expenses for conducting asset pool auctions. No fees are apparently to be charged by the Treasury to Securities PPIFs. Fund managers of Securities PPIFs are free to charge incentive fees to the fund but those fees will be “considered” by Treasury in connection with the manager’s application for pre-qualification.
 8. Regulatory Pressure. Particularly in the wake of current stress-testing, regulators may be tempted to encourage depository institutions to take advantage of these programs to sell loans or securities on terms that the institution finds unattractive.
 9. Eligibility of Foreign-owned Banks. Foreign-owned U.S. banks and thrifts (and U.S. branches of foreign banks) are not eligible to sell loans to a Loan PPIF under the Legacy Loan Program. No explanation is given for this limitation but the FDIC has stated since the announcement that it is discussing it with Treasury.
 10. Transfer of Assets to Eligible Participants. Institutions that are not eligible to participate in either program, including ineligible U.S. and foreign affiliates, may have the opportunity to transfer eligible assets to eligible participants for re-sale to a PPIF. The term sheet for neither program appears to prevent such transfers.
 11. Commercial and Political Considerations. Numerous commercial and political aspects of the programs will need to be tested, including (i) the risk of retroactive changes to the programs by Treasury and the FDIC, (ii) how to evaluate Treasury’s unilateral right to terminate its commitment to fund debt or equity, (iii) whether investors will be willing to risk the costs of their deposit and due diligence if a bank can decide not to sell loans at the winning bidder’s price and (iv) whether lenders will lend to a Securities PPIF in a position junior to Treasury’s senior secured loan.

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