

PPIP

## The Public-Private Investment Program in the US

BY SELINA HARRISON



It has been almost a year since US Treasury Secretary Timothy Geithner announced the Public-Private Investment Program (PPIP), an initiative, part of the Troubled Asset Relief Program (TARP), designed to enable financial institutions to dispose of eligible 'toxic' mortgage-backed loans and securities. Combining money from private investment funds with government funds, PPIP is aimed at stabilising the US banking sector, deploying capital and extending new credit to households and businesses. However, since it was launched, the program has not been widely utilised, leading to widespread criticism of the program's structure and planning.

The PPIP itself consists of two programs, which are the Legacy Securities Program and the Legacy Loan Program. The Legacy Securities Program involves using funding from private investors, loans from the Federal Reserve's Term Asset Lending Facility (TALF) and other TARP monies to buy mortgage-backed securities (MBS), which were originally rated AAA and commercial mortgage-backed securities (CMBS) that also had an AAA rating. The Legacy Loan Program was launched in an attempt to remove toxic residential and commercial real estate loans from banks' balance sheets, using debt financing at up to a six to one ratio supported by a Federal Deposit Insurance Corporation (FDIC) guarantee with the remaining equity to come from

private investors and the US Treasury.

### Mounting criticisms

In late January 2010, the Treasury released a report, regarding the Legacy Securities Program, detailing the progress made under the program since its launch. The report reveals that, through December 2009, the PPIP has amassed a total of \$24.8bn to buy mortgage-backed securities. That sum consists of \$6.2bn raised by just nine funds organised under the program by private sector fund managers approved by the Treasury. This amount was matched dollar for dollar by the Treasury, which also provided another \$12.4bn to the program. So far, under the Legacy Securities Program, the Treasury and investment firms have spent \$3.4bn on toxic mortgage bonds, with 87 percent of the PPIP portfolio holdings represented by private mortgage-backed securities (totalling \$2.97bn), and the remainder of the portfolio consisting of CMBS (totalling \$440m).

While the Legacy Securities Program has achieved some success, the Legacy Loan Program has faltered. Unable to persuade enough banks to sell off their bad assets, the FDIC announced in early June 2009, that it was postponing the initial sale of legacy loans, and explained that the program was under review for renewal in a different form - just three months after it was launched. "The FDIC indicated

that one of the reasons for the lack of interest is that banks have been able to raise additional capital without having to sell their legacy loans. Others have argued that the reluctance of the banking community stemmed from a desire by the banks to avoid the losses they would have to recognise upon such sales and a concern over future additional rules and regulations governing such sales," explains Merritt Cole, a partner at White and Williams LLP.

In August 2009, the FDIC conducted a test of the leveraged funding mechanism under the program. The test involved the auction of a group of residential mortgage loans that the FDIC held since November 2008, through its receivership of Franklin Bank to Residential Credit Solutions. But in late November 2009, FDIC Commissioner Sheila Blair indicated that the FDIC was continuing to develop the Legacy Loan Program, as there were still policy issues and eligibility requirements that needed to be resolved, and that the next sales would occur in early 2010.

Meanwhile, the increased attractiveness of legacy securities has led to price increases and eroded potential gains for investors in PPIP funds. As a result, the funds have raised less money than previously anticipated. In addition, the price increases have encouraged many financial institutions to hold their legacy securities, rather than sell them at depressed prices, as the market was beginning to strengthen. Not only were banks less interested in selling legacy securities, but the program also has, in effect, made many legacy securities more marketable and attractive to financial institutions.

When details of the Legacy Securities Program were announced, economist and Nobel Prize winner Paul Krugman expressed several criticisms, including that the fact this program may lead to a hidden subsidy that will be split by asset managers, banks' shareholders and creditors and therefore may encourage wild overbidding for assets. "Indeed, an early criticism was that the Legacy Security Program's terms were very generous to the elite group of fund managers, who would take advantage of the depressed securities prices to buy troubled assets," explains Mr Cole. "Before the market for these assets recovered, some funds predicted annual returns of approximately 20

percent. Since the prices of these securities have increased, and the expected returns have diminished, critics have not been as vocal." Even so, criticism of the Legacy Securities Program and PPIP on the whole is still widespread. With the Legacy Loan Program still in development stage and the Legacy Securities Program attracting less investment than anticipated, many are doubtful that the PPIP will result in any real improvement to the credit markets in the US.

Jerome W. Jakubik, a senior counsel at Baker & McKenzie LLP, believes the main negative aspect of the program is its lack of certainty or track record. "No one knows if the government, as a partner, will intrude in business decisions, particularly as pressure has arisen to avoid large-scale repossessions and foreclosures of mortgage assets, which is the principle means by which to recover a mortgage asset. Regulations have not been the problem, but the continued high delinquency rates in the mortgage sector, combined with the fact that so many mortgage loans are under water, have hampered any significant investment in this kind of asset." Mr Jakubik also feels that the financial crisis has sapped investors' confidence in real estate management advisers, although they are needed to run the PPIP. According to him, there are, at this point, very few successful and experienced advisers who are trusted by a large number of investors to manage mortgage assets, and experience is essential in order to recover funds or assets from borrowers in the current financial climate.

In addition, the Treasury has failed to put sufficient pressure on financial institutions to participate in the program. As Mr Jakubik points out, the program has also been underutilised because many of the details of the PPIP have developed too slowly, such as identifying the portfolios of assets to be disposed of and qualifying the investor groups. "Most available investment capital has been attracted to more conservative and liquid investments and not toward real estate vehicles that depend so much on an improved market for residential property in the

US, as does the PPIP. So far, the main investment banks have not significantly participated in PPIP at this point, as investors or sellers of assets have continued to hold or invest in mortgage loans independent of the PPIP," he adds. In his report to Congress, Neil Barofsky, the Special Inspector General for TARP (SIGTARP), explained that the multitude of government schemes designed to support lending and help homeowners avoid foreclosures, combined with this lack of investment by banks and private investors, has meant that the Federal government has, in essence, become the mortgage market. Indeed, the Federal programs now stretch from origination to guarantor to securitisation, and finally to domination of mortgage-backed securities.

Other criticisms include whether sufficient regulation of PPIP funds existed, amid allegations of suspect trades. Mr Barofsky has been investigating reports of suspicious activity involving fund managers selling securities from a non-PPIP fund to a PPIP fund at higher prices. In his report, published to Congress at the end of January, Mr Barofsky recommended that the Treasury take additional steps to avoid future conflicts of interest, insisting there should be walls between fund managers taking part in PPIP, which co-invests government funds with those of the private sector, and managers buying and selling similar securities.

**PPIP may still be useful**

Despite those widespread criticisms, Mr Cole notes that "the announcement of PPIP did help to improve sentiment in the marketplace and increased trading prices for legacy assets, which helped financial institutions." Several experts agree that the program has encouraged the restoration of liquidity in the market for legacy assets, and helped to improve the balance sheets of financial institutions that own legacy assets. Furthermore, PPIP has facilitated realistic valuations of legacy assets that should result, over time, in the reduction of excessive liquidity discounts in legacy asset prices.

But, on the other hand, the potential direct impact of purchases under the Legacy Securities Program may be limited. "As presently structured, the Legacy Securities Program contemplates a total investment of only \$40bn, comprising \$30bn from the government and \$10bn from the private sector PPIP funds. This represents the value of only a small fraction of the legacy securities held by financial institutions," says Mr Cole. Moreover, although the Legacy Securities Program has had a positive effect on the market for legacy securities, some investors may now believe that prices are too high to enable these assets to be of good value for PPIP funds. As a result, funds have not fully invested their capital and returns are low. However, if prices for legacy securities decrease, PPIP would be a more valuable tool to financial institutions that want to remove legacy securities from their balance sheets.

Whether the program will serve a useful purpose for the banking community remains to be seen, and even the Treasury noted in its initial PPIP report that it would be premature to draw any long-term conclusions about the performance of the program at this point. But Mr Jakubik believes that if history is anything to go by, the PPIP may likely be a success. "Establishing vehicles for nonperforming loans has been a useful tool to end a financial crisis and to permit financial institutions to redirect their attention and their balance sheets toward funding an improved business borrowing base and away from the problem mortgage sector," he says, referring to the financial turmoil that occurred in the US in the 1990s and the subsequent financial crises in Asia, Europe and Mexico, when financial institutions used strategies similar to the PPIP to stabilise their economy. Therefore, as the economy improves and the real estate market stabilises in the latter part of 2010, PPIP may – as similar programs in previous crises – prove more successful in helping financial institutions clear up their balance sheets and therefore allow them to navigate the downturn. ■



PPIP ROUNDTABLE  
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