Global Financial Restructuring

Client Alert

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U.S. Government's Legacy Asset Programs Provide Selective Opportunities to Foreign Financial Institutions and Investors

The much anticipated Public-Private Investment Programs announced by United States Treasury Secretary Geithner on March 23, 2009 contain opportunities for a broad range of private investors to access significant U.S. government debt and equity financing to acquire troubled legacy assets and for financial institutions, as sellers, to remove such assets from their balance sheets. Such opportunities, as investors or as managers of the funds to be established under the Programs, are selectively available to foreign financial institutions and other foreign investors, though the exclusion of foreign-owned U.S. subsidiaries and the U.S. branches and agencies of foreign banks from selling loan assets under the new Legacy Loans Program may be open to challenge. *

Legacy Securities Program

Purchases of commercial mortgage backed securities (CMBS) and residential mortgage backed securities (RMBS) under the Program will be made by approximately five public-private investment funds (Legacy Securities PPIFs) to be established and managed by private funds managers (Fund Managers). Legacy Securities PPIFs may invest in CMBS and RMBS issued prior to 2009 and which, at the time of issuance, had AAA ratings from two or more major rating agencies without rating enhancements from a monoline or other provider of credit support. The underlying assets must be actual mortgage loans, leases or other assets (and not other securities) and must be situated predominantly in the United States. Management of the Legacy Securities PPIFs - including pricing decisions about CMBS and RMBS purchases - will be made by the Fund Managers. Such PPIFs will be equity funded by the participating private investors (arranged

* For further background, see Baker & McKenzie's CLIENT ALERT: Treasury Secretary Geithner Outlines Principal Features of the Obama administration's Financial Stability Plan to Normalize the Financial Markets, CLIENT ALERT: U.S. Financial Stability Plan likely to benefit investors active in ABS, distressed debt, and CLIENT ALERT: US. Government $1,000 Billion Loan Faciility is Available to Non-U.S. Investors. Those and other crisis-related alerts are available on our website.

by the Fund Manager) and by the Treasury Department, which will provide equity funding equal to the private capital invested in each Fund. The Treasury Department will also make available to each Fund non-recourse debt financing equal to between 50-100% of the total equity invested in the Fund. In exchange for its contributions to the Funds, the Treasury Department will also receive warrants to the equity of each such Fund.

Fund Managers will be selected through a competitive process by the Federal Deposit Insurance Corporation (FDIC). A Fund Manager must have (i) a demonstrated capacity to raise at least $500 million of private capital, (ii) demonstrated experience in investing in eligible CMBS and RMBS, (iii) at least $10 billion of such assets under management, (iv) demonstrated operational capacity to manage a Legacy Securities PPIF, and (v) headquarters in the United States. Application forms have already been published, with an April 10, 2009 application deadline.

While not defined, the requirement that Fund Managers be "headquartered" in the United States will probably limit participation to U.S. domestic companies and to the U.S. subsidiaries of foreign-owned companies. That limitation is further reinforced by the requirement of a US$10 billion book and trading history in eligible CMBS and RMBS consisting primarily of underlying U.S. assets.

For institutions wishing to sell eligible CMBS and RMBS to such Legacy Securities PPIFs, sellers must be "financial institutions" as defined in the Emergency Economic Stabilization Act passed in October 2008, under which TARP was established. Such a "financial institution" is "any institution, including, but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any State, territory, or possession of the United States … having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government." Thus the financial institution subsidiaries in the United States of foreign companies and the U.S. branches and agencies of foreign banks will be able to sell eligible CMBS and RMBS to Legacy Securities PPIFs, provided they have significant operations in the United States. Foreign companies as owners of such CMBS and RMBS will not be able to sell to such Funds, in the absence of a qualifying U.S. subsidiary, bank branch or agency.

Legacy Loans Program

In contrast to the Legacy Securities Program for the purchase of CMBS and RMBS, there is less clarity about the operation of the Legacy Loans Program for the direct purchase of "loans and other assets", which will involve a much greater role for the FDIC. "Participant Banks" will offer pools of loans and other assets to the FDIC for purchase by a Public-Private Investment Fund (Legacy Loans PPIF). For each asset pool, a determination will be made by the FDIC and Treasury as to the equity contribution to be made by Treasury and an FDIC guarantee of debt to be raised by the Legacy Loans PPIF, as well as other terms (such as maximum leverage, which is not to exceed 6 to 1) in respect of the Legacy Loans PPIF's acquisition of such pool. FDIC will then conduct an auction of the asset pool, with private investors bidding on such asset pool, with the winning bidders becoming investors in that Legacy Loans PPIF. The Legacy Loans PPIF would then acquire such assets using the private investors' funds and the government's debt and equity financing. Each Legacy Loans PPIF would have a private sector asset manager but, in contrast to the Legacy Securities PPIFs, it would appear that such asset manager would not have the broader role of organizing the fund and arranging private sector investments. Treasury's equity contribution to any Legacy Loans PPIF will not exceed 50% of the such Fund's equity; Treasury would also be issued warrants, as in the case of Legacy Securities PPIFs.

Private investors in Legacy Loans PPIFs are expected to include a broad range of different entities, including "financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds and pension funds" though there is also a reference in the materials released by Treasury and the FDIC to "foreign investors with a headquarters in the United States." While ambiguous, it would seem that the enumerated entities are expected to include such institutions which are U.S. subsidiaries of foreign institutions and the U.S. branches and agencies of foreign banks but not foreign companies operating from outside the United States. Individuals are likely to include foreign nationals as well as U.S. citizens. The Legacy Loans Program is subject to formal rule-making (regulations) before it is implemented, and these ambiguities may be resolved in such regulations.

Participating Banks eligible to sell "loans or other assets" to Legacy Loans PPIFs are stated to be "any insured U.S. bank or U.S. savings association … [and] banks or saving associations owned or controlled by a foreign bank or company are not eligible." This would exclude U.S. banking subsidiaries of foreign banks and the U.S. branches and agencies of foreign banks.

Foreign Participation

Thus, under the Legacy Securities Program, foreign parties would appear able to bid to participate as a Fund Manager of a Legacy Securities PPIF through a U.S. subsidiary which is "headquartered" in the United States and otherwise meets the eligibility criteria for such a Fund Manager. Holders of CMBS and RMBS eligible for sale to a Legacy Securities PPIF include foreign-owned U.S. financial institution subsidiaries (other than those owned by a foreign government) and the U.S. branches and agencies of foreign banks.

Under the Legacy Loans Program, the U.S. subsidiaries of foreign financial institutions, the U.S. branches, agencies and subsidiaries of foreign banks, and foreign nationals would appear to be able to participate as private investors in Legacy Loans PPIFs. On the "sell side", foreign participation is precluded, either by the U.S. bank subsidiaries of foreign banks or U.S. branches or agencies of foreign banks. Such an exclusion is questionable as a matter of policy, is inconsistent with the treatment of foreign-owned U.S. financial institutions in other U.S. government crisis-response programs, and may violate U.S. treaty obligations under its bilateral and multilateral treaties with the countries concerned. That exclusion may be eliminated in the rule-making process to implement the Legacy Loans Program but, if not eliminated, may be subject to legal challenge by excluded institutions.