Public Funds Private Investors: Analysis of PPIP

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I. INTRODUCTION

In October of 2008, the U.S. Congress enacted The Emergency Economic Stabilization Act of 2008 (“EESA”) in response to the deterioration in the U.S. housing market and the subsequent illiquidity amongst U.S. financial institutions. The severity and scope of the financial crisis required unprecedented actions by the U.S. treasury to prevent further deterioration of the global economy. This included a $700 billion bailout of Wall Street banks and the Federal Reserve’s $1.7 trillion purchase of mortgage-backed securities to prop up faltering housing. The bailout was necessary to prevent the collapse of the American financial system and to support the recovery of a global economy that had become deeply intertwined with the U.S. financial markets.

The EESA established the Troubled Asset Relief Program (TARP), which was designed to purchase distressed financial assets and to provide capital infusions to banks in order to shore up the financial system. The EESA also authorized the Federal Reserve to make credit available to U.S. financial institutions on a large scale, in order to support the continued functioning of the financial system.

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billion dollar investment of taxpayer funds to purchase troubled assets from financial institutions and subsequently improve the flow of credit throughout the U.S. economy.3

II. WHAT CAUSED THE CREDIT CRISIS?

To understand the root cause of the financial crisis of 2008, it is important to first understand the underpinnings of the global financial system. Modern commerce depends on a string of payments to continue the proper functioning of the global economy.4 For instance, these payments can be characterized as the payments necessary to deliver a gallon of milk from farm to consumer or for delivering a new product from idea to production.5 Moreover, due to the complex and far-reaching scope of modern commerce, consumers, producers, and investors within a network of payments rely upon trust not only amongst one another, but most importantly rely upon the soundness of the financial system to ensure proper payments.6 In effect, a loss in confidence in the financial system stalls the global economy as consumers, producers, and investors will cease activity out of fear that banks will be unable to honor their agreements to make these payments.7 Accordingly, financial institutions play a vital role in the global economy as they provide credit to various parties in the chain of commerce who subsequently depend on the flow of credit to continue doing business.8 Thus a freeze in credit results in a stalled economy, which was the underlying cause of the financial crisis of 2008.9

The primary cause of the credit freeze was the subprime mortgage crisis of 2007 in which lenders extended subprime loans to mortgage applicants who were deemed high risk in terms of their potential to default.10 As financial institutions continued to take on excessive risk by lending to high risk applicants, home prices soared due to the sudden increase in demand for new homes, which created artificially inflated home prices that were also being used as collateral for these subprime loans.11 To hedge their risk, “[b]anks broke mortgages into pieces and then collected them in securities that they sold throughout the world.”12 When the housing market peaked in 2006 and the price of homes began to fall, “[t]he unraveling of [the] housing market revealed trillions of dollars worth of over-inflated assets and thousands of mortgages in or nearing default.”13 As a result, banks were forced to drastically downgrade the value of their securities, which created a loss in confidence in financial institutions prompting investors to withdraw their money from banks.14

A. New Financial Products

Traditionally, when banks created loans they profited only as they were paid back and retained the risk of default from the creation of the loan till it was fully repaid.15 By doing business at arm’s

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4. Paulson Testimony, supra note 2 (testimony of Henry M. Paulson, Jr., former Sec’y, U.S. Dep’t of the Treasury).
5. Id.
6. Id.
8. See id. at 5.
9. See id.
11. Yomarie, supra note 7, at 6.
12. Id.
13. Id.
14. Id. at 7.
length, banks had to maintain responsible lending practices by carefully evaluating each applicant’s ability to repay a loan.\textsuperscript{16} Through a process known as securitization, however, banks are now able to sell the rights to mortgage payments and the credit risk that goes along with them to investors.\textsuperscript{17} In effect, banks pool together mortgage loans creating financial products that can be broken up and later sold to investors as tradeable securities called mortgage-backed securities.\textsuperscript{18} This process became increasingly popular with banks as a means of raising new capital to offer more loans to consumers and businesses.\textsuperscript{19}

As the real estate market flourished, banks became increasingly reliant on asset-backed securities as a means of raising new capital.\textsuperscript{20} Demand for these securities soared leading to the creation of a lucrative secondary market where large volumes of asset-backed securities were regularly traded.\textsuperscript{21} To keep up with rising demand for asset-backed securities in the secondary market, lenders lowered requirements for mortgage loans to increase mortgage lending.\textsuperscript{22} Likewise, lenders sold mortgage-backed securities as a means of raising new capital to keep up with the soaring demand for mortgage loans in the housing sector.\textsuperscript{23} While this symbiotic relationship between Wall Street and Main Street lead to a period of great prosperity in all facets of the U.S. economy, their dependence made the entire economy extremely vulnerable to an economic collapse.\textsuperscript{24}

B. The Collapse

In August of 2007, the housing market began to cool and home prices fell from over inflated levels to prices more reflective of actual market conditions.\textsuperscript{25} As home prices declined, recent home buyers found themselves with mortgages worth far more than the actual value of their homes, which caused many to choose default as a less expensive alternative than continued payments on their mortgages.\textsuperscript{26} Subprime mortgages extended to risky borrowers inevitably went into default as many loan originators failed to properly evaluate their applicants’ ability to repay loans.\textsuperscript{27} As borrowers stopped

16. Id.
17. Id. at 33.
18. Id. (asserting that securitization is a common method used by banks to decrease their exposure to risk).
19. Id. at 35 (noting that more than 80% of subprime loans had been securitized by 2007).
21. Id. at 35.
22. Id. at 21–22.

What went wrong with global economic policies that had worked so effectively for nearly four decades? The breakdown has been most apparent in the securitization of home mortgages. The evidence strongly suggests that without the excess demand from securitizers, subprime mortgage originations (undeniably the original source of crisis) would have been far smaller and defaults accordingly far fewer. But subprime mortgages pooled and sold as securities became subject to explosive demand from investors around the world. These mortgage backed securities being “subprime” were originally offered at what appeared to be exceptionally high risk-adjusted market interest rates. But with U.S. home prices still rising, delinquency and foreclosure rates were deceptively modest. Losses were minimal. To the most sophisticated investors in the world, they were wrongly viewed as a “steal.”


23. See Moran, supra note 15, at 33. “As securitization became increasingly popular in recent years, home finance became more focused on feeding the appetites of national and global investors instead of assisting home buyers in their choice of an appropriate loan.” Id.

24. See id.
25. See id. at 54.
27. See Greenspan Testimony, supra note 22 (testimony of Alan Greenspan, former chairman, Bd. of Governors, U.S. Fed Reserve Sys.).

The consequent surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem. Demand became so aggressive that too many securitizers and lenders believed they were able to create and sell mortgage backed securities so quickly that they never put their shareholders’ capital at risk and hence did not have the incentive to evaluate the credit quality of what they were selling. Pressures on lenders to supply more “paper” collapsed subprime underwriting standards from 2005 forward. Uncritical acceptance of credit ratings by purchasers of these toxic assets has led to huge losses.
making payments, the demand and thus the value of mortgage-backed securities rapidly declined, which forced many investors within the massive secondary market of these securities to sell them back to the banks in which they originated.28

C. Toxic Assets

A key measure of strength for any financial institution is the notion that investors and other financial firms are confident that the institution they are investing in have “real assets standing behind its investments.”29 Consequently, confidence in financial institutions waned as many of them were forced to incur massive write-downs on their balance sheets to reflect the significant losses in the value of asset-backed securities.30 As such, asset-backed securities—once in high demand by investors—became known as “toxic assets” due to their severely declined value and lenders’ inability to find investors to purchase them.31

As losses continued to mount, banks struggled to maintain enough capital forcing investors to quickly pull their funds out of the market out of fear that banks would be rendered insolvent.32 As a result, many lenders became unable or unwilling to provide credit to businesses and consumers due to dangerously low levels of capital on hand.33 The tightened credit market ultimately stalled the global economy, which prompted calls for massive government intervention.34

III. THE GOVERNMENT INTERVenes

In light of the financial crisis, Congress passed the Emergency Economic Stabilization Act in order to stabilize the nation’s financial system.35 Although this Act was effective in averting a complete financial meltdown of the global economy, the U.S. economy continued to deteriorate, albeit at a much slower rate had the government not taken any action at all.36 As banks tightened credit, confidence in the

Id.
29. Id.
30. Id.
32. Paulson Testimony, supra note 2 (testimony of Henry M. Paulson, Jr., former Sec’y, U.S. Dep’t of the Treasury).
33. Geithner Testimony, supra note 3 (testimony of Timothy Geithner, Sec’y, U.S. Dep’t of the Treasury).
34. Moran, supra note 15, at 85.
35. EESA, supra note 1, § 101, 122 Stat. at 3765; see also Geithner Testimony, supra note 3 (testimony of Timothy Geithner, Sec’y, U.S. Dep’t of the Treasury).
36. Geithner Testimony, supra note 3 (testimony of Timothy Geithner, Sec’y, U.S. Dep’t of the Treasury).
financial system waned causing many consumers and businesses to be far more cautious in spending money. 37 Although many experts argue that less government intervention is more beneficial to a free market, the government argued that a laissez faire approach to the financial crisis would prolong and deepen the current recession. 38

By enacting EESA, Congress attempted to revive the U.S. credit market by assisting financial institutions in selling bad real estate loans and the securities backed by these loans. 39 To accomplish this aim, the EESA provides the Secretary of the Treasury the authority to purchase legacy assets through a program called the Public-Private Investment Program (“PPIP”). 40 The program is designed to use $75 to $100 billion in taxpayer funds allocated by TARP concomitant with capital from private investors to purchase legacy assets from banks. 41 The initial goal is to generate $500 billion to purchase legacy assets with the ultimate goal of expanding to $1 trillion over time. 42 In effect, the government is creating demand and thus a market for these assets. 43 As a result, the government expects the value of these assets to rise and most importantly “reduce uncertainty about the scale of losses on bank balance sheets,” which will make it easier for banks to raise private capital and increase lending capacity. 44

A. PPIP’s Three Basic Principles

Legacy assets have created a loss in confidence in financial institutions as their balance sheets reflect millions and in some cases billions of dollars in nonperforming, illiquid assets. 45 Most investors are reluctant to purchase legacy assets from banks due to their uncertain value and volatility. 46 Moreover, to avoid realizing major losses on their balance sheets, many banks are reluctant to sell legacy assets at a discounted rate since actual market conditions may reflect significantly lower values for these assets than the values listed on their balance sheets. 47 In effect, the once thriving market for legacy assets has ceased to exist. 48 Moreover, the lack of buyers and sellers for these assets has caused significant uncertainty as to their value. 49 In addition, PPIP has drawn strong criticism because of the use of public funds and the

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37. Id.
38. Id. (“Leaving [the] situation unaddressed would have undoubtedly risked a deeper recession and more damage to the productive capacity of the American economy. It would have resulted in higher unemployment and greater failures of businesses.”).
39. See EESA, supra note 1, § 101, 122 Stat. at 3767. See also Geithner Testimony, supra note 3 (testimony of Timothy Geithner, Sec’y, U.S. Dep’t of the Treasury).
40. EESA, supra note 1, § 101, 122 Stat. at 3765. “The Secretary shall implement any program under paragraph (1) through an Office of Financial Stability, established for such purpose within the Office of Domestic Finance of the Department of the Treasury, which office shall be headed by an Assistant Secretary of the Treasury . . .” Id.
42. Timothy Geithner, My Plan for Bad Bank Assets, WALL ST. J. ASIA, Mar. 24, 2009, at 15. “Over time, by providing a market for these assets that does not now exist, this program will help improve asset values, increase lending capacity by banks, and reduce uncertainty about the scale of losses on bank balance sheets.” Id.
43. Id. See Jonathan R. Laing, The Latest Bailout Move: Finally Some Hope, BARRON’S, Mar. 30, 2009, at 25 (asserting that investors will pay more for legacy assets if they are able to obtain cheap and secure financing to purchase them).
44. Geithner Testimony, supra note 3 (testimony of Timothy Geithner, Sec’y, U.S. Dep’t of the Treasury).
45. Id.
47. Laing, supra note 44. Banks might be reluctant to part with residential and commercial-real-estate loans at a big discount from face value of 100, particularly if the borrower is making steady payments. Such a sale could erode bank capital, potentially leading to dilutive equity sales or even to a seizure by the Federal Deposit Insurance Corp.
48. See PPIP FACT SHEET, supra note 42.
high level of risk to which they will be exposed. To ensure public funds are invested prudently and the program achieves its ultimate objective, PPIP will be based around three basic principles.

1. Maximizing the Impact of Public Funds

The first principle is to use taxpayer funds efficiently and prudently. The core of PPIP’s design is the investment of private capital in the purchase of legacy assets. Through the use of government financing, the Treasury expects to attract private capital by providing private investors with 50% of the financing to buy legacy assets. The benefit of this approach is that the government can effectively achieve its aim of removing legacy assets from financial institutions’ balance sheets without expending greater TARP funds.

2. Shared Risk and Profit

The second principle is the sharing of risk and profits between taxpayers and private investors. “[T]he [PPIP] ensures that private sector participants invest alongside the taxpayer, with the private sector investors standing to lose their entire investment in a downside scenario and the taxpayer sharing in profitable returns.” In effect, the 50/50 equity partnership between taxpayers and private investors will allow the taxpayer to share in any profitable returns from the investment. To attract investors, however, the Treasury designed PPIP to allow taxpayers to assume much of the downside risk by providing nonrecourse loans for the sale of these assets. Thus, the Federal Reserve, in conjunction with the Federal Deposit Insurance Company, will allow banks to sell off their unwanted legacy loans with up to 6-1 leveraging to the winning bidder. The FDIC will then guarantee the debt ensuring investors will lose no more than the amount of their investment while the taxpayer stands to lose any losses beyond that amount. Although PPIP places the taxpayers’ portion of the investment in much greater risk than the investors’ portion, the Treasury intended this unequal distribution of risk by design as a means of attracting investors to purchase legacy assets.


See Legacy Securities Fact Sheet, (asserting that the “resulting need by investors and banks to reduce risk triggered a wide-scale deleveraging in [the securities] markets and led to fire sales.” The result is a negative cycle where “declining asset prices have triggered further deleveraging, which has in turn led to further price declines” and few buyers as investors refuse to purchase assets with an uncertain value.).

50. See Geithner, supra note 43.
51. PPIP FACT SHEET, supra note 42 (noting basic principles of PPIP).
52. Id.
53. Id.
54. See id.
55. See Elliot, supra note 50, at 12. “Private sector funding is a useful complement to the government’s own resources. . . . Since Congress is highly resistant to approving more TARP funding, it makes sense to bring in as much outside money as possible. . . . In addition, the Fed has a strong cultural bias against taking significant risk.” Id.
56. PPIP FACT SHEET, supra note 42.
57. Id.
58. Id.
59. Id.
60. Id.
61. PPIP FACT SHEET, supra note 42.
62. Id.; see also Geithner Testimony, supra note 3 (testimony of Timothy Geithner, Sec’y, U.S. Dep’t of the Treas.).
3. Price Discovery

PPIP’s third principle is designed to utilize the private sector as a means of setting the price of legacy assets. The Treasury’s intent with regards to this aspect of PPIP is to “reduce the likelihood that the government will overpay for these assets.” By attracting investors with generous incentives, particularly a 50/50 equity partnership and 6 to 1 leveraging, the Treasury will be artificially creating demand for legacy assets and thereby a market in which they will be freely traded. Additionally, allowing actual market conditions to set the price for legacy assets will make their purchase far more palatable to investors rather than a government proposed price. A major challenge in the purchase and sale of legacy assets is the uncertainty as to their value. Accordingly, a key component of PPIP is the use of private investors to determine the value of legacy assets. By attracting private investors, PPIP will revive the market for these assets where economic and market conditions will allow private investors to dictate their value. Moreover, the 50/50 equity split between taxpayer funds and private capital will give investors additional incentive to invest in legacy assets.

IV. Two Programs Under PPIP

The Treasury designed PPIP to account for two types of assets: legacy loans and legacy securities. Legacy loans consist of billions of dollars in distressed real estate loans that have weighed down bank balance sheets since the decline in the housing market. Legacy securities, on the other hand, consist mostly of commercial and residential mortgage-backed securities that were created by banks that pooled together individual real estate loans and sold them as securities. After eligible banks identify the distressed assets that they would like to put up for sale, the FDIC will oversee the formation of Public-Private Investment Funds (“PPIFs”) and the subsequent purchase of loans and other assets from banks. The FDIC notes that the need for two separate components—one dealing solely with legacy loans and another dealing solely with asset-backed securities—is based on the different structuring of the two types of financial products. In effect, the Legacy Loans Program was designed to deal with “whole loans” and the sale of whole loans “by banks to the investment fund,” whereas the Legacy Securities Program will focus on securitized assets and focus on issues related to the securities market including to mark to market pricing.

63. PPIP Fact Sheet, supra note 42.
64. Id.
65. See id. See also Elliot, supra note 50, at 12 (asserting that “[t]he best method anyone has found for valuing an asset is to see what price would be arrived at between willing buyers and willing sellers competing freely.”).
66. Elliot, supra note 51, at 12.
68. PPIP Fact Sheet, supra note 42.
69. See id.
71. PPIP Fact Sheet, supra note 42.
72. WHITE PAPER, supra note 47.
73. Id.; see Geithner, supra note 43.
74. PPIP Fact Sheet, supra note 42.
75. Transcript, supra note 71.
A. **Legacy Loans Program**

The Legacy Loans Program is designed to attract private capital to purchase distressed loans from banks.\(^77\) In addition, this program will encourage private investors to work with the government to restore clarity and liquidity to the credit market as troubled loans have drastically reduced banks’ lending capabilities and confidence in the U.S. market.\(^78\)

To participate in this program, banks holding distressed assets must identify which asset pools they would like to put up for auction through PPIF.\(^79\) The Treasury is encouraging banks to identify and sell assets “with a view to restoring maximum confidence for depositors, creditors, investors, and other counterparties.”\(^80\) Moreover, to ensure the focus of this program remains on reviving the U.S. credit market, the Treasury has designed the program to ensure that only U.S. banks are permitted to sell their assets under PPIF and any collateral supporting eligible assets must be “situated predominantly in the United States.”\(^81\) In effect, this provision will ensure that PPIP’s focus will remain on removing distressed real estate loans for commercial and residential properties that lead to the initial credit crisis.\(^82\)

After banks have identified the assets they would like to sell under PPIP, the FDIC will be responsible in approving the assets and coordinating the creation of the PPIFs.\(^83\) PPIFs will be the investment vehicles established to “purchase pools of loans and other assets” from participating banks.\(^84\) Moreover, the FDIC will be responsible for overseeing the formation, funding, and operation of PPIFs while the Treasury will be responsible for managing its 50% equity contribution to the PPIFs.\(^85\) In effect, once asset pools have been designated for each PPIF, the FDIC will assess the amount of debt it will guarantee for each asset pool\(^86\) and then coordinate the sale of equity stakes in each PPIF to private investors through an auction process.\(^87\)

Furthermore, once an eligible asset pool has been identified for auction, the FDIC will select a third party valuation firm to assess the value of each asset pool.\(^88\) This party will be responsible for analyzing each asset pool to determine their value based on characteristics including “expected cash flows based on types of interest rates, risk of underlying assets, expected lifetime losses, geographic exposures, maturity profiles and other relevant factors.”\(^89\) Based on this information, the FDIC will determine the

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\(^77\) **PPIF FACT SHEET, supra** note 42. See **White Paper, supra** note 47. “A wide array of investors are expected to participate. The program will particularly encourage the participation of individuals, mutual funds, pension plans, insurance companies, and other long-term investors.”

\(^78\) **PPIF FACT SHEET, supra** note 42; see also **TRANSCRIPT, supra** note 71.

\(^79\) **PPIF FACT SHEET, supra** note 42.


\(^81\) See id.

\(^82\) Id.; see also **TRANSCRIPT, supra** note 71 (statement of Sheila Bair, Chairman, Bd. of Dirs., Fed. Deposit Ins. Corp.) (stating that the FDIC “would like to target legacy real estate-related assets starting off. So, [the FDIC will] be looking at high risk mortgages and commercial real estate. That’s where we’re going to start. I don’t think we’ll limit it to that, but it’s where we want to put our first priority”).

\(^83\) **SUMMARY, supra** note 81.

\(^84\) Id.

\(^85\) Id.

\(^86\) **PPIF FACT SHEET, supra** note 42. Leverage will be determined by an independent third party and is not expected to exceed a 6 to 1 debt to equity ratio. **SUMMARY, supra** note 81.

\(^87\) **SUMMARY, supra** note 81.

\(^88\) Id.

\(^89\) Id.
amount it is willing to leverage for each asset pool.\textsuperscript{90} Private investors will then use this information to determine the amount they are willing to bid for a PPIF with control of the fund going to the highest bidder.\textsuperscript{91}

The winning bidder will then have to provide 50\% of the equity position in the PPIF with the Treasury providing the remaining 50\%.\textsuperscript{92} To encourage private investors to purchase larger portions of asset pools, the FDIC will provide credit support in the form of nonrecourse debt to private investors to finance the purchase of PPIFs.\textsuperscript{93} In other words, private investors in a PPIF will lose no more than the amount of their investment if the PPIF’s value falls to zero.\textsuperscript{94} However, as a result of the 6 to 1 leveraging private investors could earn up to six times more profit in an upside scenario.\textsuperscript{95}

B. Legacy Securities Program

The second component of PPIP is the Legacy Securities Program designed to revive the market for legacy securities.\textsuperscript{96} The ultimate goal of this program is to set up public-private investment funds or PPIFS to encourage private sector investors to purchase distressed asset-backed securities from banks and thereby improve banks’ lending capabilities to consumers and businesses.\textsuperscript{97} In addition to improving liquidity in the market, the Legacy Securities Program will improve the market’s ability to set prices for these securities.\textsuperscript{98} The assets that banks may include for sale in this program will be initially limited to commercial mortgage-backed securities and residential mortgage-backed securities issued prior to 2009.\textsuperscript{99} “The Legacy Securities Program consists of two related parts designed to draw private capital into these markets by providing debt financing from the Federal Reserve under the Term Asset-Backed Securities Loan Facility (“TALF”)\textsuperscript{100} and through matching private capital raised for dedicated funds targeting legacy securities.”\textsuperscript{101}

\begin{table}
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90. \textit{Id.} \\
91. \textit{Id.} Banks will have the option of accepting or rejecting the highest bid. \textit{SUMMARY, supra} note 81. \\
92. \textit{Id.} \\
93. \textit{Id.} To illustrate the formation of a PPIF the Treasury provided this sample investment: If a bank has a pool of residential mortgages with $100 face value that they are seeking to divest, the bank would approach the FDIC. The FDIC would determine, according to the above process, that they would be willing to leverage the pool at a 6-to-1 debt-to-equity ratio. The pool would then be auctioned by the FDIC, with several private buyers submitting bids. The highest bid from the private sector – in this example, $84 – would define the total price paid by the private investors and the Treasury for the mortgages. Of this $84 purchase price, the Treasury and the private investors would split the $12 equity portion. The new PPIF would issue debt for the remaining $72 of the price and the debt would be guaranteed by the FDIC. This guarantee would be secured by the purchased assets. The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis – using asset managers approved and subject to oversight by the FDIC. Through transactions like this, the Legacy Loans Program is designed to use private sector pricing to cleanse banks’ balance sheets of troubled assets and create a more healthy banking system. \textit{WHITE PAPER, supra} note 47. \\
94. \textit{See PPIF FACT SHEET, supra} note 42. \\
95. \textit{See id.} \\
96. \textit{Id.} \\
98. \textit{Id.} \\
99. \textit{U.S. TREAS. DEP’T OF PUB. AFFAIRS, SUMMARY OF TERMS: LEGACY SECURITIES PROGRAM} (2009) [hereinafter SUMMARY II], available at http://www.treas.gov/press/releases/reports/legacy_securities_terms.pdf. Similar to the Legacy Loans Program, eligible legacy securities must have originally been rated AAA when they were initially issued or “an equivalent rating by two or more nationally recognized statistical rating organizations” and the loans and underlying assets must be situated “predominantly in the United States.” \textit{Id.} \\
100. [A] facility that will help market participants meet the credit needs of households and small businesses by supporting the issuance of asset-backed securities (ABS) collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration (SBA). Under the TALF, the Federal Reserve Bank of New York (FRBNY) will lend up to $200 billion on a non-recourse basis to holders of certain AAA-rated ABS backed by newly and recently originated consumer and small business loans. \textit{See generally} Press Release, Bd. of Governors, Fed. Reserve Sys. (Nov. 25, 2008), available at http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm. \\
101. \textit{PPIF FACT SHEET, supra} note 42.
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1. Legacy Securities and TALF

The first component of the Legacy Securities Program is expanding TALF to include legacy securities.\textsuperscript{102} By expanding TALF, PPIP will make financing available to investors in the form of nonrecourse loans from the Treasury and the Federal Reserve.\textsuperscript{103} Prior to this expansion, TALF’s purpose was to provide nonrecourse loans to investors in asset-backed securities collateralized by “newly and recently originated consumer and business loans” particularly those backed by car purchases, college educations, and real estate.\textsuperscript{104} By expanding TALF, investors may now purchase legacy assets that were formed prior to 2009, particularly real estate loans issued during the recent housing bubble.\textsuperscript{105} Currently, however, only certain “high-quality mortgage-backed securities . . . are eligible collateral under the TALF.”\textsuperscript{106} Although residential mortgage-backed securities will not be included initially, the Federal Reserve and the Treasury will most likely expand the program to include these securities based on the initial success of the program.\textsuperscript{107}

2. Legacy Securities PPIP

The second component of the Legacy Securities Program is the Legacy Securities Public-Private Investment Program, which is set to invest up to $30 billion of equity and debt to purchase legacy securities.\textsuperscript{108} Similar to the Legacy Loans Program, the Legacy Securities PPIP will establish investment funds using nonrecourse loans to attract private investors to invest alongside the government.\textsuperscript{109}

a. Fund Managers

Unlike the Legacy Loans Program, the Legacy Securities PPIP will utilize nine private sector fund managers to raise the private capital for the private side of the investment.\textsuperscript{110} Once selected, fund managers will have up to twelve weeks to raise $500 million in equity capital from private investors.\textsuperscript{111} To ensure fund managers are fully invested in the success of this program, the Treasury requires fund

\textsuperscript{102.} Id.
\textsuperscript{103.} Id.
\textsuperscript{104.} Press Release, Joint Statement, supra note 98 (emphasis added).
\textsuperscript{106.} Press Release, Joint Statement, supra note 98.
\textsuperscript{107.} Id.
\textsuperscript{108.} Id.
\textsuperscript{109.} Legacy TALF and the Legacy Securities PPIP are separate programs. Legacy TALF will be a Federal Reserve lending program with its own set of terms, conditions and eligibility requirements. Legacy TALF will be made widely available to investors (who meet Federal Reserve eligibility standards) regardless of whether or not they participate in the Legacy Securities PPIP. Pre-qualified Fund Managers in the Legacy Securities PPIP may choose to utilize leverage pursuant to the Legacy TALF program, when it becomes operational and subject to its terms and conditions. For the avoidance of doubt, a qualified investor utilizing Legacy TALF will do so on the same terms and conditions as a Legacy Securities PPIP investor utilizing Legacy TALF.
\textsuperscript{110.} Treasury evaluated these applications according to established criteria, including: (i) demonstrated capacity to raise at least $500 million of private capital; (ii) demonstrated experience investing in Eligible Assets, including through performance track records; (iii) a minimum of $10 billion (market value) of Eligible Assets under management; (iv) demonstrated operational capacity to manage the Legacy Securities PPIP funds in a manner consistent with Treasury's stated Investment Objective while also protecting taxpayers; and (iv) headquartered in the United States. To ensure robust participation by both small and large firms, these criteria were evaluated on a holistic basis and failure to meet any one criterion did not necessarily disqualify an application.
\textsuperscript{109.} Questions, supra note 109.
\textsuperscript{111.} Press Release, Joint Statement, supra note 98.
managers to invest a minimum of $20 million in firm capital into the PPIF.\textsuperscript{112} Moreover, the Treasury will match the total amount of equity capital raised on a 1-1 basis.\textsuperscript{113} In addition to this amount, the Treasury will also provide a nonrecourse loan matching up to 100\% of the total equity in the PPIF.\textsuperscript{114} Moreover, to ensure the prices of asset-backed securities purchased by PPIFs reflect actual market value, fund managers will be given full control over the selection of assets, pricing, asset liquidation, trading, and disposition.\textsuperscript{115}

V. POTENTIAL LOOHOLES AND WEAKNESSES

A. Taxpayers’ Burden

Many analysts argue that the 50/50 equity split between taxpayers and private investors is unfair to the taxpayer as taxpayers will assume 100\% of the risk on the lending side, while receiving only 50\% of any returns on the investment.\textsuperscript{116} The FDIC Chairman asserts that the success of this program relies not only on reviving the market for legacy assets, but also discovering prices for these assets that many banks have been unable to accurately price on their balance sheets due to the lack of buyers.\textsuperscript{117} Thus giving investors a greater share of the profit while assuming no risk as to the leveraged loan will not only attract more private investors, but also aid the market in determining more accurate market based pricing.\textsuperscript{118} Moreover, the upside potential for taxpayers is not necessarily in the form of actual returns from the PPIF, but rather increased lending by banks, which will promote economic growth and increased lending for consumers such as loans for mortgages, credit cards, and car loans.\textsuperscript{119}

B. Government’s Exit Strategy

PPIP is designed to create demand for legacy assets through generous incentives in the form of government financing and nonrecourse loans, this then raises the question: how will this market sustain itself once the government pulls out and the artificially created demand no longer exists? Moreover, many analysts question the ability of the government to pull the taxpayers’ investment out of PPIP once the program has achieved its stated goals.\textsuperscript{120} In effect, taxpayers are subsidizing private investors to

\begin{itemize}
\item \textsuperscript{112} Id.
\item \textsuperscript{113} Id.
\item \textsuperscript{114} Id.
\item Step 1: Treasury will launch the application process for managers interested in the Legacy Securities Program.
\item Step 2: A fund manager submits a proposal and is pre-qualified to raise private capital to participate in joint investment programs with Treasury. Step 3: The Government agrees to provide a one-for-one match for every dollar of private capital that the fund manager raises and to provide fund-level leverage for the proposed Public-Private Investment Fund. Step 4: The fund manager commences the sales process for the investment fund and is able to raise $100 of private capital for the fund. Treasury provides $100 equity co-investment on a side-by-side basis with private capital and will provide a $100 loan to the Public-Private Investment Fund. Treasury will also consider requests from the fund manager for an additional loan of up to $100 to the fund. Step 5: As a result, the fund manager has $300 (or, in some cases, up to $400) in total capital and commences a purchase program for targeted securities. Step 6: The fund manager has full discretion in investment decisions, although it will predominately follow a long-term buy-and-hold strategy. The Public-Private Investment Fund, if the fund manager so determines, would also be eligible to take advantage of the expanded TALF program for legacy securities when it is launched.
\item \textsuperscript{115} See Press Release, Joint Statement, supra note 98.
\item \textsuperscript{116} See Transcript, supra note 71 (statement of Sheila Bair, Chairman, Bd. of Dirs., Fed. Deposit Ins. Corp.).
\item \textsuperscript{117} See id.
\item \textsuperscript{118} Id.
\item [W]e've hit the right balance, using private investors to price, with government providing some low priced financing, diffuse liquidity premium, at our current market prices which are selling at very, very deep discounts, when they are selling at all. So, again, I think this is the best possible structure to get that pricing mechanism going, and get it to a place where buyer and seller are going to meet.
\item Id.
\item \textsuperscript{119} See id.
\item \textsuperscript{120} See Transcript, supra note 71 (statement of Sheila Bair, Chairman, Bd. of Dirs., Fed. Deposit Ins. Corp.).
\end{itemize}
purchase these assets, which will ultimately increase demand for them and thereby increase their value to prices that banks would normally not receive without PPIP.\textsuperscript{121}

The FDIC, however, argues that the decreased value of legacy assets is a result of the credit crisis and their current values are not an actual reflection of their true market value.\textsuperscript{122} In other words, the decreased capacity of banks to lend money is the reason investors are not purchasing real estate loans.\textsuperscript{123} Consequently, it is investors’ inability to purchase real estate loans through the use of credit that has created an inaccurate perception of lowered values for these assets.\textsuperscript{124} Thus, PPIP gives private investors low cost government financing to purchase these assets to, in a sense, bridge the gap between banks and private investors by providing investors with the financing that banks are unable to provide for the purchase of these assets.\textsuperscript{125}

Furthermore, the drastically decreased value of legacy assets has also increased the cost of credit for consumers and businesses.\textsuperscript{126} Thus, increasing liquidity in the market will ultimately spur economic growth as banks resume normal lending. The net effect will be a sustained increase in the value of these legacy assets without the government’s assistance, which will then allow the Treasury to withdraw the taxpayers’ funds from these investments.\textsuperscript{127}

C. Vulnerabilities

To ensure proper oversight, the EESA created several independent offices to review certain aspects of TARP.\textsuperscript{128} More specifically, to minimize fraud and abuse, the EESA created the Office of the Special Inspector General to oversee purchases, expenditures, and revenue for TARP.\textsuperscript{129} In addition to its oversight responsibilities, the Inspector General must also find potential loopholes and weaknesses in TARP and set forth recommendations for the Treasury to improve TARP.\textsuperscript{130}

In a recent Quarterly Report to Congress, the Special Inspector General argued that PPIP’s design could make it “inherently vulnerable to fraud, waste, and abuse.”\textsuperscript{131} Moreover, many potential investors in PPIP, such as hedge funds, are substantially unregulated.\textsuperscript{132} Additionally, the complex, interconnected nature of the financial market and the number of smaller entities controlled by large financial institutions gives banks the opportunity to exploit PPIP by investing in their own legacy assets, driving up prices, and thereby accrue profits in the form of taxpayer funds.\textsuperscript{133}

1. Conflicts of Interest

The most vulnerable aspect of PPIP is the potential for private investors to make “investment decisions that benefit themselves at the expense of the taxpayer.”\textsuperscript{134} As a result of the uncertain values of legacy assets and the lack of buyers in the market for these assets, fund managers selected by the Treasury

\begin{itemize}
  \item \textsuperscript{121} See id.
  \item \textsuperscript{122} Id.
  \item \textsuperscript{123} Id.
  \item \textsuperscript{124} Id.
  \item \textsuperscript{125} See TRANSCRIPT, supra note 71 (statement of Sheila Bair, Chairman, Bd. of Dirs., Fed. Deposit Ins. Corp.).
  \item \textsuperscript{126} See id.
  \item \textsuperscript{127} See id. Chairman Bair contends that that PPIP is “structured to be profitable over the long term [and] that the taxpayers should capture a lot of that.” See id.
  \item \textsuperscript{128} EESA, supra note 1, § 121(f)(1), 122 Stat. at 3792.
  \item \textsuperscript{129} Id.
  \item \textsuperscript{130} Id.
  \item \textsuperscript{132} Id. at 147.
  \item \textsuperscript{133} See id.
  \item \textsuperscript{134} Id.
\end{itemize}
may have the ability to dictate the price of these assets by simply overpaying for them.\(^{135}\) In other words, fund managers in control of legacy assets can drive up the prices of these assets by intentionally purchasing additional assets at rates much higher than their actual market value and thereby setting the price for those assets at the inflated price.\(^{136}\) Although both taxpayers and investors will profit initially, the value of these assets will eventually fall to levels more reflective of actual market conditions.\(^{137}\)

### 2. Collusion

Another area of concern with regards to PPIP’s vulnerabilities is that it creates a significant loophole that may allow banks to collude with one another to use government funding as a means of swapping legacy assets at inflated prices.\(^{138}\) Moreover, the significant leveraging available to private investors creates a great incentive for buyers and sellers to collude at the taxpayers’ expense.\(^{139}\) For instance, a bank holding legacy assets can create a PPIF under the Legacy Loan Program to purchase the legacy assets of another bank.\(^{140}\) The problem is that each bank in this scenario is investing a small amount of equity in a PPIF to attain up to six times as much funding from the government in the form of a nonrecourse loan.\(^{141}\) In effect, the two banks in this situation can make a surreptitious agreement to place excessively high bids to purchase the other’s legacy assets.\(^{142}\) Consequently, each bank in this situation could earn a substantial profit with this arrangement by simply over-bidding on the other’s assets using government funding.\(^{143}\) The net effect of such arrangements would allow banks to earn substantial profits, yet leave the same amount of legacy assets on their balance sheets, thereby impeding the ultimate aim of this program.\(^{144}\)

### 3. Fund Managers and Non-PPIF Funds

Although the Treasury and Congress have enacted a number of policies to improve transparency and deter fraud and abuse of PPIP, there remains a significant loophole within the program that may provide investors with opportunities to defraud the program.\(^{145}\)

Due to the significant power fund managers’ will have in setting prices for legacy assets and the substantial sums of money to be invested in PPIFs, access to information known solely by a particular fund managers that is not publically available may create an opportunity for abuse.\(^{146}\) For instance, knowledge of future purchases by a PPIF or the price the PPIF will pay for particular assets may create these opportunities.\(^{147}\) This poses a particular problem with regards to fund managers making decisions on behalf of the PPIF and employees within that fund manager’s company managing other non-PPIF funds.\(^{148}\) A common method that may be employed to deal with this situation would be to create “strict information barriers” between fund managers of the PPIF and other employees within the same

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135. \textit{Id.}
136. \textit{See Quarterly Report I, supra note 132, at 147.}
137. \textit{Id.}
138. \textit{See id.}
139. \textit{Id.}
140. \textit{See id.}
141. \textit{See Quarterly Report I, supra note 132, at 147.}
142. \textit{See id.}
143. \textit{See id.}
144. \textit{See id.}
146. \textit{Id.}
147. \textit{Id.}
148. \textit{Id.}
company. These barriers may include a separation of technology and facilities to ensure valuable information is not disseminated to parties who have an opportunity to abuse the program.

D. Possible Solutions

To counter these weaknesses, the Treasury has adopted a number of recommendations to improve transparency and prevent fraud and abuse in PPIP. For instance, the Treasury requires all fund managers to invest a minimum of $20 million in firm capital to ensure fund managers make prudent investment decisions that are in the best interest of all parties in the investment fund. In addition, Congress amended the Helping Families Save Their Homes Act of 2009 to include the Public-Private Investment Program Improvement and Oversight Act of 2009. This Act “require[s] each manager of a public-private investment fund to acknowledge, in writing, a fiduciary duty to both the public and private investors in such fund[s].” These fiduciary duties, however, may act as a disincentive to many fund managers as it is common practice for most fund managers to expressly disclaim any fiduciary duty to their investors.

Due to the substantial amount of leveraged financing provided to private investors and the opportunity to abuse these loans, this Act also requires the Treasury Secretary to consult with the Special Inspector General to issue regulations with regards to the interaction between PPIP and the TALF.

Additionally, Congress also imposed strict conflict of interest rules on private sector managers of PPIFs to ensure “securities bought by the funds are purchased in arms-length transactions, that fiduciary duties to public and private investors in the fund are not violated, and that there is full disclosure of relevant facts and financial interests . . .” In effect, Congress’ intent is to increase transparency between investors and the banks selling the legacy assets. As a result, Congress requires each PPIF to “make a quarterly report to the Secretary of the Treasury . . . that discloses the 10 largest positions of such fund . . .”. Additionally, this Act requires investors to retain all records relating to the PPIF and provide full disclosure of such records to the Special Inspector General. The intent behind these provisions is to deter collusion and conflicts of interest. Moreover, in light of the taxpayers’ position as an investor in these funds, taxpayers have a reasonable expectation in knowing how their money is being used. Thus, transparency in transactions between buyers and sellers of legacy assets not only prevents collusion and conflicts of interest, but also ensures that investors will maintain their fiduciary duties to all investors involved.

PPIP also requires fund managers to invest a minimum of $20 million to reduce conflict of interest issues. This investment ensures fund managers will act prudently and in the best interest of their investors because a substantial investment of firm capital will be directly affected by the fund managers’ decisions. Moreover, in an effort to mitigate conflicts of interest, the Inspector General recommends the creation of an “Eligible Asset Watch List,” which is a list of all positions held by each

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149. Id. at 176.
151. Id.
152. Id.
153. EESA, supra note 1, § 101, 122 Stat. at 3767.
154. Id.
155. See Quarterly Report I, supra note 129, at 147.
156. EESA, supra note 1, § 101, 122 Stat. at 3767.
158. EESA, supra note 1, § 101, 122 Stat. at 3767.
159. Id.
160. See Quarterly Report I, supra note 129, at 150.
161. See id.
162. See id.
164. See id.
fund manager, its clients, and named affiliates.\textsuperscript{165} This requirement allows proper oversight over all transactions made by fund managers.\textsuperscript{166} In addition to disclosing investors’ positions, the Inspector General also recommends full disclosure of all beneficial owners in a PPIF to allow for greater oversight and thereby mitigate potential conflicts of interest.\textsuperscript{167}

VI. \textbf{CONCLUSION}

The recent collapse of the global financial markets and the subsequent collapse of the credit market created a sense of urgency within the government to restart the flow of credit. The government’s solution to the credit crisis is a rather clever plan to lure private investors using public capital. Moreover, it is a better alternative than a plan that uses solely public funds, which would be extremely unpopular, expensive, and ineffective. Further, allowing large U.S. banks to become insolvent and go into bankruptcy would create an economic crisis not seen since the Great Depression.

Although the economy has shown signs of recovery in recent months,\textsuperscript{168} there is still potential for the economy to stall once again. From this point forward, it is important for the government to strike a balance between ensuring adequate regulation over the financial system to prevent a similar crisis in the future without over-regulating and thereby stifling economic growth. Although PPIP offers banks an opportunity to cleanse their balance sheets, the potential for fraud, abuse, and perhaps a similar crisis based on the same premise may be all too likely.

\textsuperscript{165} Id.
\textsuperscript{166} See id.
\textsuperscript{167} Id. at 172.
\textsuperscript{168} United States GDP contracted at an annualised rate of 1 per cent between April and June, compared with the same period in 2008. That was significantly better than the consensus expectation of a 1.5 per cent annualised fall. However, the US Bureau of Economic Analysis also downgraded its earlier estimates for growth, with a 6.4 per cent annualised decline now given as the reading for the first quarter of this year, even worse than feared.

Sean O’ Grady, \textit{America May be Over Her Worst Recession in 60 Years}, INDEPENDENT (London) Aug 1, 2009 at 44.