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REPORT

Public-Private Investment Program

PPIP Late to the Party, but Positioned To Take Pressure Off Polluted Portfolios

For more than two years federal officials have recognized the need to remove ''toxic'' assets from financial institutions' balance sheets and only now the Public-Private Investment Program (PPIP) is coming online with a realistic chance of helping to accomplish that goal.

Portfolios loaded with often exotic and complex residential or commercial financial products, many of questionable value, have been widely regarded as part and parcel of the economic meltdown. Yet dealing with them has been among the last policy objectives related to the financial crisis that the Federal Reserve Board and administration have implemented.

To underscore the confounding nature of problem, PPIP involves specially selected investment fund managers, whose stake in purchasing eligible assets must be matched dollar-for-dollar with federal funds. Then the transactions will be leveraged with non-recourse loans from the Federal Reserve Bank of New York. Further, only assets that were originally rated AAA will qualify for purchase under the program, suggesting that many billions of dollars of truly toxic credits will not be directly involved in PPIP. Experts say many of them already have been written off.

Jump-Starting Markets. But analysts are cautiously optimistic the policy will have its intended effect simply by restarting a market for loans that has been all but frozen since the latter half of 2007. Of the nine funds participating in the PPIP Legacy Securities initiative, five have raised at least $500 million in investment capital, as required by the Treasury Department. Invesco Ltd. and TCW Group Inc. reached that minimum commitment for their Public-Private Investment Funds (PPIFs) in September, and on Oct. 5, Treasury announced three others—AllianceBernstein, LP and its sub-advisers Greenfield Partners, LLC and Rialto Capital Management, LLC; BlackRock Inc.; and Wellington Management Company, LLP—also reached the minimum funding level.

Those five PPIFs so far have raised a combined $3.07 billion from private sources. According to Treasury, the purchasing power suggested by the firms' fundraising, plus the federal match and leverage amounts to $12.27 billion in debt and equity so far. Treasury indicated the four other funds also are expected to announce initial fund closings before the end of October. Over the coming six months, all nine will have an opportunity for two additional closings, bringing the total potential debt and equity level of the program to about $40 billion.

PPIP is not the only federal policy designed to help restart the real estate mortgage markets; it is closely linked with the Term Asset-Backed Securities Loan Facility (TALF), which already has moved about $4.5 billion in legacy commercial mortgage-backed securities (CMBS) off institutions' balance sheets.

Complementary to TALF. TALF uses non-recourse loans from the New York Fed Bank to leverage the purchase of AAA-rated CMBS that were issued before Jan. 1, 2009. Private entities began acquiring assets under the program in July. PPIP is similar to TALF in that it uses the same Fed leverage, but acquisitions will also enjoy the advantage of federal matching funds for the PPIFs.

Also, TALF so far has not involved residential mortgage-backed securities (RMBS); PPIP will allow the fund managers to buy up both RMBS and CMBS.

The additional measure of subsidy provided under PPIP also relates to the potential differences in the quality of assets. Whereas TALF-eligible securities must receive a top rating by at least two rating agencies, and no ratings below AAA, PPIP guidelines indicate that eligible assets must have ''originally'' received the top ratings. Many so-called legacy assets have declined in quality as the real estate markets themselves have lost value.

The securities most likely to be purchased under PPIP are held by larger financial institutions, including insurance companies and pension funds, rather than small or medium-sized banks, which tend to hold whole commercial real estate loans on their books. One industry source said the PPIP transactions will be one-off sales.

''They're not like [Federal Deposit Insurance Corporation] auctions . . . '' the source said, adding ''The point of this is to buy them from viable institutions to keep them out of the FDIC's auction process.''

Some observers have indicated PPIP sales could be affected by potential sellers' reluctance to take losses.

Owners Reluctant to Sell. ''I think the issue with PPIP is that a lot of the banks that own a lot of the 'troubled assets' are reluctant to sell those assets and essentially establish a marketplace for the remainder of their portfolio, which would require them to presumably mark the rest of their portfolio down to the price at which the PPIP assets got sold,'' said Steven Marks, managing director for the Fitch Ratings REIT unit. ''So I think that's why PPIP really hasn't gotten under way.''

''The problem is these are not worth what they're being carried for,'' another source said. ''But they're worth more than what people have been offering to buy them from the banks. So there's this huge gap.''

The federal equity and generous debt offerings are designed to shift market attitudes toward the Legacy Securities and thereby close that gap.

He noted, however, that the ability of the PPIFs to raise private equity capital is itself a vote of confidence for the program.

''I take comfort from that fact that they have raised as much money as they have. There are a lot of investors out there who are betting with their money that this will work,'' he said.

Also, TALF has been successful in leveraging purchases of more than $50 billion since March in existing CMBS as well as other types of asset-backed securities, such as credit card and auto loan securities.

''I don't bet against the government when they have all the money in the world,'' the source said.

Even the $40 billion that Fed and Treasury officials hope to pump into the securitized real estate market in the coming months appears to be a drop in the bucket compared to the levels of CMBS and RMBS that could be purchased under PPIP. According to Citigroup, about $589 billion in Legacy CMBS are eligible for acquisition through the program and about $1.4 trillion in RMBS are eligible.

But many observers say anticipation of the program itself has begun to move the markets. Over the two-week period after Legacy Securities first became eligible for acquisition in early July under the TALF program, Citigroup research analysts noted that TALF-eligible CMBS bonds rallied from an interest rate spread of about 700 basis points to a spread of only 400 basis points. Citi also said in a July report that, given the market rally, the various categories of TALF-eligible bonds ''have pretty much reached their projected price targets under the TALF financing.''

The analysts suggested that based on the market reaction to TALF, similar beneficial effects on the market for PPIP-eligible securities also will occur. However, they added that the success of the PPIF managers in raising capital also will be a factor in the program's ability to move markets. That picture should become more clear in the coming weeks and months as all nine PPIF advance their fundraising activities.

In an Oct. 9 statement, the Real Estate Roundtable said, ''Although PPIF Securities purchases have not yet begun, the program has already been successful in driving liquidity and significant tightening in the commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS) markets.''

Another source who provided advice to federal policymakers on PPIP told BNA Oct. 9, ''The bottom line is you free up $40 billion in assets and you use that money to then make new loans and those new loans turn into new CMBS that actually perform well. Then all CMBS will benefit from that.''

By Richard Cowden

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