

U.S. Structured Finance Newsletter

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PIIP: MORE ALPHABET SOUP

The Public-Private Investment Program (PIIP) is the latest initiative by the U.S. Treasury to unfreeze credit markets. The program has been positively received by investors as evidenced by the response of broad-market equity and ABX indices rallied on the day of its release.¹ Unlike previous Treasury efforts, the PIIP is a bifurcated approach that is government backed with private investment participation. The aim of the PIIP is to deal with distressed mortgages and mortgage-backed securities, both of which are presumably marked higher on bank balance sheets than the market.² Banks that benefit from PIIP liquidity are expected to resume lending; however, the economics of the writedown calls into question its feasibility for certain banks.

One of the major parts of the PIIP is the Legacy Loan Program (LLP), which facilitates liquidity. Banks receive liquidity from proceeds of individual auctions in which mortgage loan portfolios are sold to the highest bidder. Given the distressed state of the secondary markets, a bank would likely recognize a writedown if the winning bid is lower than the mark of the portfolio on the balance sheet. As shown in Table 1 (assuming the market price is correct), the \$84 accepted bid on a portfolio with a \$100 face value would result in a \$16 writedown to the selling bank. Even though the sale would accomplish liquidity, it would also spur the need to raise significant capital by the bank.

Table 1: Economics of Legacy Loans Program Investment

\$100	Face value of mortgage loan portfolio	
	\$16	Write-down
	\$84	Purchase price:
	\$72	FDIC-guaranteed debt financing (Max 6:1 leverage)
	\$12	Equity:
	\$6	Private investor equity contribution (50%)
	\$6	Treasury equity contribution (50%)

Source: www.ustreas.gov/press/releases/tg65.htm.

The LLP is expected to yield at least \$500 billion in purchasing ability with leveraged financing backed by the Federal Deposit Insurance Corporation (FDIC) and equity contributions provided by private investors and the Treasury. As shown in Table 1, the private investor who won the auction would issue \$72 of pool-collateralized debt that is guaranteed by the FDIC. The remaining \$12 would be funded in equal allotments of equity contributions by the Treasury and the private investor. Hypothetically, the private investor achieves 14:1 leverage while retaining control of the disposition of the portfolio in order to maximize his return.

It is of note that the LLP will employ at least three control features to mitigate credit losses allocated to the government and, effectively, the taxpayer. One, the FDIC will provide a maximum of 6:1 leverage on the combined equity contribution. Two, independent third parties will determine the maximum debt to be guaranteed with the issuance after an analysis of the mortgage loan collateral. Three, the FDIC will maintain active oversight of the entire process (auction, servicing, accounting and reporting).

It is evident that the LLP is designed to stimulate bank liquidity by narrowing the bid-ask spread on mortgage loans in the secondary market. The bid-ask spread has widened over time because sellers are not motivated to recognize the accounting treatment that would result from accepting bids lower than the current marks. The LLP may narrow this spread by prodding likely buyers to sweeten their bids with enticements of leverage, subsidized financing and matching equity contributions. It remains unanswered how losses, if any, will be allocated and the amount of upside a private investor can expect given the federally backed incentives.

For questions or comments, please contact Bernard Maas at bmaas@dbrs.com.

1. On March 23, 2009, the Dow Jones Industrial Average closed up 6.8%. On the same day, ABX 06-1 AAA, 06-2 AAA, 07-1 AAA and 07-2 AAA indices closed up 3.0%, 3.0%, 5.4% and 4.5%, respectively.

2. A number of large banks have already reduced the marks on loan portfolios in connection with bank mergers.