



MEMORANDUM

DATE: August 2009

TO: All PCA Clients

FROM: Pension Consulting Alliance, Inc. (PCA)

RE: Review and Investment Recommendation on PPIP Investment Opportunities

Background

The financial crisis, which started with the collapse of the U.S. property market in mid-2007, has triggered \$1.52 trillion of writedowns and credit losses at banks and other financial institutions. Due to these massive writedowns banks began hoarding capital and curtailed lending. This deleveraging process greatly reduced credit availability, restricting economic expansion. The Government determined that one of the best ways to revive lending was to remove the toxic assets weighing on banks' balance sheets. In an attempt to cleanse U.S. banks' balance sheets of distressed loans and securities, the Federal Deposit Insurance Corporation (FDIC) and U.S. Treasury are launching the Public-Private Investment Program (PPIP). It is the Government's view that by addressing the problems created by legacy assets, PPIP should help to improve the health of the financial institutions holding the assets. The Government believes that this should lead to an increased flow of credit throughout the economy and to a stabilization of financial markets. PPIP is designed to draw new private capital into the market for "legacy" assets (those currently on banks' balance sheets) by providing Government equity co-investment and attractive Government financing. The program is anticipated to facilitate price discovery and should help, over time, to reduce the excessive liquidity discounts embedded in current legacy asset prices. The primary areas of focus for PPIP are the residential and commercial mortgage sectors, including both whole loans and securitized pools (mortgage securities) backed by loan portfolios. Currently, only the portion of the program aimed at "legacy" mortgage securities is being implemented.

Recommendation

PCA has reviewed the features and structures of investments associated with the U.S. Government's Public-Private Investment Program. While there are numerous tradeoffs (see following table), PCA believes that PPIP-oriented investments do not necessarily offer investors the best risk/return profiles when compared to other opportunistic fixed income investments. Therefore, PCA believes its clients should closely examine the merits and concerns of PPIP, in the context of an overall approach to investing in opportunistic/distressed fixed income.



Summary of PPIP’s Merits and Concerns

Merits	Concerns
<ul style="list-style-type: none"> Potential for double-digit returns generated from capital appreciation and income spreads. 	<ul style="list-style-type: none"> Lack of investment liquidity. Investors will face long lock-up periods (8+ years) while still being subject to potential capital calls.
<ul style="list-style-type: none"> Exploiting fixed income credit-oriented dislocation that will likely diminish materially within a short to intermediate time frame. 	<ul style="list-style-type: none"> Credit risk analysis required. Managers performing credit analysis on investment collateral will likely be some of the same managers that failed to mitigate the credit risks during the sub-prime crisis.
<ul style="list-style-type: none"> Government is offering highly attractive financing rates to participating investors. 	<ul style="list-style-type: none"> Leveraged positions. The use of leverage magnifies the chance and extent of loss.
<ul style="list-style-type: none"> Assets are not required to be marked to market thus there is no requirement to post additional margin due to a decline in asset value. 	<ul style="list-style-type: none"> Small pool of investment managers from which to choose. Considerable distressed debt expertise in asset class left out of Program.
	<ul style="list-style-type: none"> Potential for high investment management fees and misalignment of interest.
	<ul style="list-style-type: none"> Potential for term mismatch risk between investment collateral and Treasury/TALF loans.
	<ul style="list-style-type: none"> Potential headline/political risks (think TARP).
	<ul style="list-style-type: none"> Government-sponsored program may be subject to terms revisions in the future.
	<ul style="list-style-type: none"> Complex structured securities will require high levels of scrutiny and due diligence.
	<ul style="list-style-type: none"> Highly volatile and illiquid market for the assets.
	<ul style="list-style-type: none"> Uncertainty associated with price discovery.
	<ul style="list-style-type: none"> Market Value Trigger: limited or deferred cash flows. PPIP contains provisions that limit payments to investors and provisions that force early debt repayment.

On July 8th the U.S. Treasury announced the approval of nine firms to manage the “legacy securities” portion of PPIP. The firms each have up to 12 weeks to raise at least \$500 million of capital from private investors. Due to this condition, investors and investment managers are working on a tight timetable to evaluate and fund PPIP investments. PCA’s due diligence has revealed many inherent hurdles involved with the “legacy securities” portion of PPIP. Foremost of which is the nature of the assets being purchased. The assets to be purchased are legacy senior residential mortgage-backed securities (RMBS) and legacy senior commercial mortgage-backed securities (CMBS) which have fallen dramatically in price during the current economic downturn, have been re-rated, and will likely continue to exhibit significant credit and default risks. The U.S. Treasury and its retained investment managers contend that a large factor in the price drop of these assets has been an excessive (irrational) illiquidity discount embedded in the legacy asset prices. PCA is less sanguine on viewing the low prices as strictly an illiquidity discount. Other hurdles include the highly sensitive nature of the underlying asset to the macroeconomic fundamentals. In other words, if the economy continues to deteriorate the losses on the legacy assets are likely to increase substantially. PCA also views the ratings on the legacy assets with a healthy amount of skepticism. The fact that an asset that once had a rating of AAA got “hit” with multiple-tier rating downgrades simultaneously is not reassuring.



PCA is also concerned with the tepid rollout of the Program. When first announced, PPIP was envisioned purchasing \$500 billion to \$1 trillion in assets from financial institutions. This has been scaled back to a mere \$40 billion. \$40 billion is a relatively insignificant dollar amount since there are currently \$2.1 trillion in non-Agency RMBS and \$1.1 trillion in CMBS outstanding. This scaling back can reflect either improving economic conditions resulting in less need for such a broad program or a lack of confidence in PPIP. There are many indications that PPIP may no longer be needed and that its continued, albeit smaller, rollout is more symbolic than substantive. For example, with CMBS inclusion in the TALF Program (with the possibility of also including RMBS) it becomes redundant to have two Government programs aimed at the same asset class(es). Also recent compromises in fair value accounting rules make holding legacy assets less onerous for financial institutions which may make it less likely they will sell assets below what they view as fair value. PCA believes PPIP offers an interesting investment opportunity. However due to numerous uncertainties, PCA concludes clients must exercise considerable caution when weighing the merits of a PPIP investment.

If, after consideration of the merits and concerns, a plan sponsor wishes to proceed with pursuing a PPIP investment, there are several factors that PCA views as important in determining the future success of the investment strategy. The single most important factor will be investment manager/fund selection. Investment manager selection will go far in determining whether the investor receives attractive returns or suffers losses. Like any other credit-oriented fixed income investment, security selection remains a paramount concern when participating in the Program. A successful manager will not be able to rely solely on the rating agencies ratings when determining the attractiveness of a particular asset. Instead a successful manager must be able to complete the necessary due diligence on each potential investment. This will involve scrutiny of the underlying collateral and an independent appraisal of the assets, terms and conditions. These requirements will dictate, to a degree, which investment managers will be better suited for the Program.

Summary Description of PPIP

PPIP was created by the U.S. Treasury, in conjunction with the FDIC and the Federal Reserve, to address the challenge of exiting poor performing “legacy” assets that still remain on bank balance sheets. The Program is part of the Government’s efforts to repair balance sheets throughout the financial system and ensure that credit is available to households and businesses. The FDIC will provide oversight for the formation, funding, and operation of new public-private investment funds (PPIFs) that will purchase loans and securities from depository institutions. The PPIP will attract private capital through an FDIC debt guarantee and Treasury equity co-investment. The Treasury will be responsible for overseeing and managing its equity contribution in the PPIFs, while the FDIC will be responsible for overseeing and managing its debt guarantees to the PPIFs.

Basic Principles: Using \$10 billion of capital from private investors combined with as much as \$30 billion in Government capital and loans should allow the PPIFs to generate modest purchasing power to buy legacy assets, with the possibility to expand the Program. The Government designed PPIP around three basic principles:

- *Maximize the impact of each taxpayer dollar:* By using Government financing in partnership with the FDIC and Federal Reserve and co-investment with private sector investors, modest purchasing power will be created, making the most of taxpayer resources.
- *Shared risk and profits with private sector participants:* 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.



- *Private sector price discovery:* To reduce the likelihood that the Government will overpay for the assets, private sector investors competing with one another will establish the price of the loans and securities purchased under the program.

PPIP has two parts, addressing both the legacy mortgage securities and legacy whole loans clogging the balance sheets of financial firms:

- *Legacy Mortgage Securities:* The Legacy Mortgage Securities Program is the part of PPIP that seeks to have private investors purchase eligible legacy senior CMBS and RMBS from financial institutions. Eligible assets are defined as CMBS and RMBS issued prior to 2009 that were originally rated AAA by two or more nationally recognized rating agencies. The assets will include both fixed and floating rate securities across the credit spectrum, including prime, subprime, and Alt-A mortgages. Under this Program, the Treasury will match private investments dollar for dollar through an allocation from the Troubled Asset Relief Program (TARP). Financing will be offered by the Treasury and the Term Asset-Backed Lending Facility (TALF).
- *Legacy Loans:* The Legacy Loans Program will use public and private investment funds to purchase existing residential, commercial and possibly other pooled loans from financial institutions. Under this program, private capital will partner with the Treasury to purchase these legacy loans. The Treasury will match all private investments dollar for dollar. Currently this portion of PPIP is still in the planning phase. PCA has encountered an increasing degree of doubt pertaining to the eventual implementation of the legacy loans portion of PPIP in its original design.

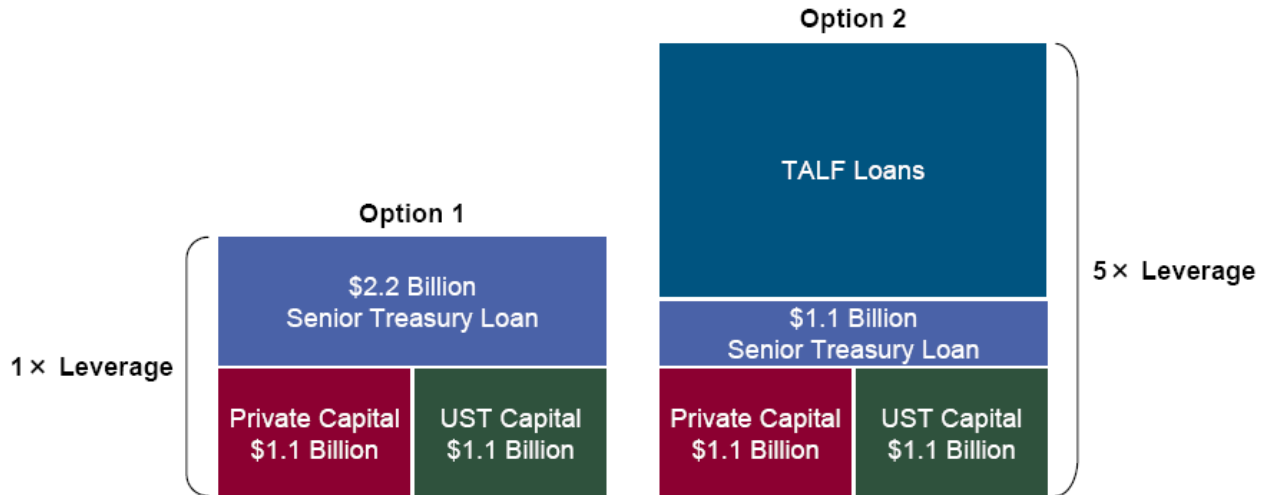
Overview of the PPIP Legacy Mortgage Securities Program

On July 8th the Treasury announced the approval of nine firms to manage the “legacy securities” portion of PPIP, several of which have private equity connections and have experience buying distressed assets. Each firm has up to 12 weeks to raise at least \$500 million of capital from private investors. The private money will then be matched with equity capital from the Treasury and topped off with leverage of up to 100% of total equity.

An investor in the PPIP Mortgage Securities Program can gain leverage in two ways: i) take the full amount of leverage offered by the Treasury which doubles the amount of capital committed by the investor and the capital committed through TARP or ii) the investor can take half of the leverage offered by the Treasury and then combine it with the initial capital to purchase TALF-eligible CMBS. The second option greatly increases the amount of leverage possible from the Program (please see the following graph).



PPIFs Structural Options



Source: AllianceBernstein

The two leveraging options have different terms and conditions that the investor must take into account when determining their financing options (please see exhibit below). The “full turn” option uses only the leverage available from the Treasury while the “half turn” option uses a combination of financing from the Treasury and the TALF program. The second “half turn” option is required to follow the much stricter guidelines for asset purchases laid out in the TALF. For example, the CMBS must currently be rated AAA by at least two rating agencies.

PPIP Financing Terms

Terms	Option 1: “Full Turn”	Option 2: “Half Turn”
Amount of US Treasury Debt	Up to 1.0 × total committed capital	Up to 0.5 × total committed capital
Cost	LIBOR + 100 b.p. plus warrant to US Treasury of 2.5%	LIBOR + 200 b.p. Plus warrant to US Treasury of 1.5%
Additional Leverage	Not permitted	Additional senior debt can be sourced from NY Fed TALF Legacy Program and permitted third parties
Maximum Leverage	1.0 ×	5.0 ×

Source: AllianceBernstein

Fund Structure

Investment funds that PCA has reviewed are structured as limited partnerships (or equivalent) in which investments will be drawn-down to fund investments. Such offerings vary in structures and terms. Legal term lengths are eight years with optional extension periods. The expected general partner compensation structures typically comprise a flat fee plus a percentage of investment profits (i.e., “carried interest”), typically 20%. The carried interest stipulation may contain a hurdle rate or preferred return.



Benefits of the PPIP Mortgage Securities Program

- Potentially large returns. On a returns basis, the opportunity present in a PPIP investment is considerable due to the potential price appreciation and the high current yields available on legacy assets. There is the potential for a highly attractive return on investment due to the large discount at which assets are currently selling. This provides the investor with the potential to earn a high IRR, similar to high-risk private equity and alternative investments on originally AAA rated securities. Currently, many managers are quoting the mid-twenties as the expected return target.
- Non-recourse loans from the Treasury and TALF Program. One key characteristic of the PPIP that makes it a potentially attractive investment opportunity is the non-recourse funding provided by the Government through the Treasury and the use of TALF loans. This form of lending is stable and allows the investor to capitalize on leveraging the initial margin posted by as much as 5 times. This feature allows the investor to capture 50% (the Government capital receives the other 50%) of the earnings power generated from the investment while only posting a small fraction of the total capital. The fact that the loans are non-recourse to the borrowers (investment managers) limits the potential downside to the initial margin collateral posted.
- No mark-to-market accounting. Another potential consideration is the fact that PPIP will not be under the mark-to-market restriction. In other words, the investor will not be required to post additional collateral if the assets fall in value (i.e. no margin calls). This is a vast difference versus other leveraged investments which are required to mark illiquid assets to market prices and post additional margin collateral, thus adding to the liquidity risk of the investment.

Concerns about the PPIP Mortgage Securities Program

- Asset price at maturity may be below par. This risk is present in the PPIP due to the fact that investment collateral utilized by the PPIP is not backed by the Government. The fact that the investor is buying legacy assets increases risk because the loans were underwritten to lower standards than today and many of the assets are already impaired. This compares to the assets available under the initial version of TALF which are underwritten to today's high credit standards and are well subordinated. In contrast, the credit risk associated with investing in PPIP is analogous to credit risk that would be borne by a portfolio of typical distressed credit-oriented securities.
- Only nine initial managers. The Treasury has decided to choose only nine initial managers for the Program which greatly limits the breadth of manager selection that PCA usually requires when recommending a manager. By limiting the pool to the nine selected the Treasury has left a significant amount of top investment talent on the sidelines.
- The Government could change the rules of the Program retroactively. This could take the form of new restrictions on investors. Thus far, the Government has not clearly communicated their intentions on the longer-term stability of the Program's policies and procedures. There are many potential unintended consequences inherent in the Program. For example, the Program has potential to exhibit significant political and headline risk (think TARP).



- Use of leverage. Investors in PPIP benefit from favorable borrowing terms from the Treasury and TALF lending facility. The investors are looking to profit from the spread between the investment return and the borrowing costs in addition to anticipated price appreciation. However, if losses in the underlying collateral are unexpectedly high, investors in the AAA tranche could suffer losses. The losses will be exacerbated by the leverage component of the respective PPIFs.
- Market Value Trigger. The Program contains an asset coverage test that is based on the market value of the PPIF's assets. If the PPIFs use the full turn of leverage option, this test will be breached if assets fall by 25% however, the test becomes incrementally tighter if the manager elects to use the half turn of leverage option. If the test is breached, then cash flow must be used entirely to pay down debt thereby reducing leverage and eliminating payments to the investors. In addition, even if there has been no decline in market value since inception, PPIFs can only make a maximum equity payment of 8% per annum. Any cash flow above that amount has to be used to pay down debt and equity on a sinking schedule. The schedule starts out pro-rata but by year 5, 100% of the cash flows above this amount must be used to deleverage.
- Potential conflicts of interest are a major concern of the PPIP Program. One potential conflict of interest rests with rating agencies. Rating agencies play a critical role in the management of this Program due to the fact that the assets must have been originally AAA-rated (and currently AAA-rated by at least two rating agencies to be eligible for TALF loans). Many of the eligible assets have now suffered multi-tier downgrades due to deteriorating fundamentals. Unlike TALF investments, the assets purchased do not have to be currently rated AAA. Instead the investment manager has the discretion to purchase assets of any credit quality. While the rating agencies are revising their procedures to address their crisis-related failures, any rating by the rating agencies should be viewed with a healthy amount of skepticism. In addition, independent due diligence should be conducted by the investment manager. Thus, it will be vitally important for the asset manager to be able to accurately analyze and price the underlying collateral. In fact, a lack of credit oversight by active managers caused many institutional investment portfolios to underperform significantly during the 2008 credit crisis. Another potential conflict of interest arises with the investment managers. Asset managers have large incentives to promote and sell their PPIP products. The nine managers selected have only 12 weeks to fund \$500 million in investments or they are not eligible for the full benefits of the Program. This means, at the margin, they will be highly motivated to gather assets, possibly downplaying potential concerns.
- Mismatch of cash flows. Another potential concern that may arise from an investment in the Program is the mismatch of cash flows between the investment collateral and commensurate Treasury and TALF loan(s). Even if the investment manager correctly matches maturity/duration between the collateral and the loans, there remains the possibility that payments of the two cash flow streams may be different. While interest is payable monthly on the TALF loans there is no guarantee that the interest earned on the collateral will be paid monthly (or at all).