

PPIP: SO WHAT DO WE THINK?

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It has been our view that a recovery in the U.S. economy must be supported by healthy banks who are willing to expand their lending, and that banks must first shed their toxic assets and attract new capital for any recovery to begin. Last week's launch of the Public-Private Investment Program ("PPIP") was an important step which we would characterize as "necessary, but not sufficient". The program sets in motion a process to help banks dispose of their toxic assets, but it does not address the large incremental capital requirements of the banking system. A review of the PPIP design, its potential benefits to the banking system and the economy, and other lingering challenges in the banking sector are discussed below.

PPIP: KEY FEATURES

The Treasury, Federal Reserve, and FDIC have joined forces in an attempt to unlock the flow of credit and jumpstart a stalled U.S. financial system. The plan calls for private investors and the government to share equally in the equity capital of 5 investment partnerships. The terms and structure for loan and security purchases are modestly different. When purchasing "toxic" loans, this equity would then be leveraged up to six times with loans guaranteed by the FDIC. When purchasing "toxic" securities, this capital would be augmented with Treasury loans of 50%–100% of equity. Importantly, all loans are non-recourse, which means that potential investors are risking only the equity they post, not the total value of the investments purchased. The program plans to use \$75–\$100 billion of TARP funds, with the goal of removing up to \$1 trillion of troubled assets from bank balance sheets. Will banks be willing to sell assets at the prices offered? Will private investors be willing to partner with government in the purchase of these distressed loans/securities? Those are the unanswerable questions right now.

BANKING SECTOR CAPITAL CHALLENGES

The U.S. financial system has been plagued with the combination of too much leverage and a deterioration of asset quality. Not only have banks been slow to liquidate troubled assets, but they have also been reluctant to re-price them to market-clearing levels. To do so would open up a significant capital shortfall for many institutions and, in some cases, could result in insolvency. The U.S. banking system needs a significant capital infusion from the private sector as Administration officials have been quite outspoken about their desire to maintain private sector ownership of banks (e.g. no nationalization). There are three significant hurdles to an investor-led recapitalization of the banking system in the short run — the ongoing slide in the economy, the lack of transparency regarding impaired assets, and the concern over future government intervention. A successful PPIP can help address some, but not all, of these hurdles.

What started as a problem in one corner of the structured products market — sub-prime mortgages — quickly infected the financial markets, resulting in widespread asset price

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declines. Despite the best efforts from policymakers, the financial markets' crisis soon metastasized into the real economy, not only in the U.S., but around the world. As economic activity has plummeted, businesses have been quick to adjust their cost structures and shed labor at a historic rate. In the U.S., the reported unemployment rate has now reached over 8% while alternative measures that include discouraged and part-time workers have climbed to the low-teens. We think this trend is firmly in place and further increases in unemployment to around 10% would not surprise us. Consumer spending remains constrained as the rise of job insecurity, wealth destruction, and the need to shore-up household balance sheets through increased savings have all added to this deleterious feedback loop. As a result, delinquencies and defaults for even high quality loans have hit record highs, and future loan performance trends are increasingly uncertain.

While traditional broker-dealers had to mark their books to market, banks have had the luxury of avoiding this re-pricing by classifying assets as "held-to-maturity" ("HTM"). The rationale from bankers is that if borrowers are still paying debt service, there is no reason to mark down the loan. Investors, on the other hand, are interested in economic exposure that, by definition, is price sensitive. Mortgage, construction, and consumer loans made over the past several years are simply not worth what they once were.

Financial institutions have been reluctant to price their own assets at levels derived from "distressed" transactions in the marketplace. Ironically, during the sizeable banking consolidations of the past 12 months (e.g. JP Morgan's purchase of Washington Mutual, Wells Fargo's purchase of Wachovia, and PNC's purchase of National City), acquiring banks were not shy about marking down the assets of their targets. Again, the important issue here concerns the economic asset value relative to capital, and many investors are unwilling to commit additional capital until this issue is resolved.

PPIP POTENTIAL OUTCOMES

The PPIP does have the potential to catalyze a recovery in financial assets. For the last 18 months, the financial markets have lacked an effective price discovery mechanism for toxic loans and securities. While trades have occurred, overall volume has been minimal and there has been virtually no new issuance. The presence of attractive, non-recourse government financing should serve to transfer wealth from taxpayers to the private investors who participate in the program. In addition, the availability of this financing should serve to raise the price investors are willing to pay for these assets, enhancing value for banks as well. Leveraged PPIP investors will seek a significant margin of safety given the volatility of these assets and their sensitivity to economic uncertainty. As a result, although prices might rise as the liquidity premium is reduced over time, we expect prices for a range of toxic assets to remain depressed. Moreover, a significant pricing gap will likely persist between where these assets are marked, and where they are likely to clear the

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market. Assets sales that result in realized losses will require the replenishment of capital.

A natural question is why would a bank voluntarily sell? The answer: the choice may not be theirs. As announced several weeks ago, the Federal Reserve is in the midst of stress-testing the largest U.S. banks. Through this stress testing mechanism, the Fed may use its regulatory powers to force writedowns, and ultimately, toxic asset sales. As a result, we think it is plausible that the PPIP will provide much needed price discovery that should serve as the basis for lower, and more uniform, marks on bank balance sheet assets. Attaining greater consistency in the valuation of loans and securities will help address the lack of transparency which has troubled investors.

But there are risks to addressing the valuation of banks' assets. At its envisioned size of \$1 trillion, the PPIP may only be about *half the size* required to adequately cleanse banks of their toxic assets. Furthermore, the asset-quality problems and solvency of weaker institutions will no longer be cloaked under the veil of HTM accounting. This could again force some very difficult government decisions as a successful PPIP may require an expansion of the program and hence, more government funding. Ironically, the more successful is the program, the greater the selling of toxic assets, the greater the pressure on prices, and the greater the incremental capital required.

PARTNERING WITH GOVERNMENT – ANOTHER WILDCARD

There is also bona-fide fear of adverse government intervention. As the current financial crisis has evolved, the response from our policy makers has been a patchwork of incremental programs. Policymakers' decision-making framework and criteria remain opaque and somewhat arbitrary. Early investors of equity capital into the U.S. financial system have incurred significant losses and there is a justifiable worry of further dilutive government actions. Even from a debt-holder's perspective, there is growing concern that bondholders might be asked to share in recapitalizations should Congress decide it is unwilling to appropriate additional funds for this purpose. So investors remain leery about taking risks that are materially subject to the unpredictability of government actions.

The media has been fixated over bonuses at AIG and the corresponding tax legislation making its way through Congress. Not surprisingly, PPIP participants should be concerned that they might be forced to comply with government-mandated compensation rules. Private investor participation either through the PPIP or through direct investment is crucial to the U.S. Government achieving its broader goal of restoring the free flow of credit to qualified households and businesses. At its essence, the PPIP investment partnerships represent leveraged vehicles purchasing volatile assets. As such, we would expect the participants to include large global capital pools as well as hedge funds and private equity firms — some of whom may have already taken government capital injections and thus may be subject to potential compensation limits. What these buyers

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have in common is the risk tolerance to stomach the underlying volatility, and the dedicated resources to select individual loans/securities that present the most favorable risk/return profiles.

The U.S. Government needs a functioning banking system to transmit its policies to the real economy. The PPIP may be effective in improving the transparency of bank assets, and in removing some of them from bank balance sheets. To do so, however, the impending capital shortfall still needs to be addressed. So the PPIP is a necessary, but not sufficient, program to restore health to the banking system and the economy. A large scale bank recapitalization plan also needs to be put forward in order for a comprehensive solution to be forged. The PPIP is an important step forward, but more work lies ahead.

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