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# The UST/FDIC Public Private Investment Program

*Ripley's*  
**Believe It or Not!**

**It Could Benefit Community Banks**



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*This is the seventh in a series of material designed to help community banks keep abreast of the challenges and opportunities created first by the Bush Administration's response to the nation's credit crisis (TARP in 2008) and now by the Obama Administration's FSP in 2009. Materials we have previously prepared can be found on our website - [www.go2griffin.com](http://www.go2griffin.com). We plan to update as developments occur.*

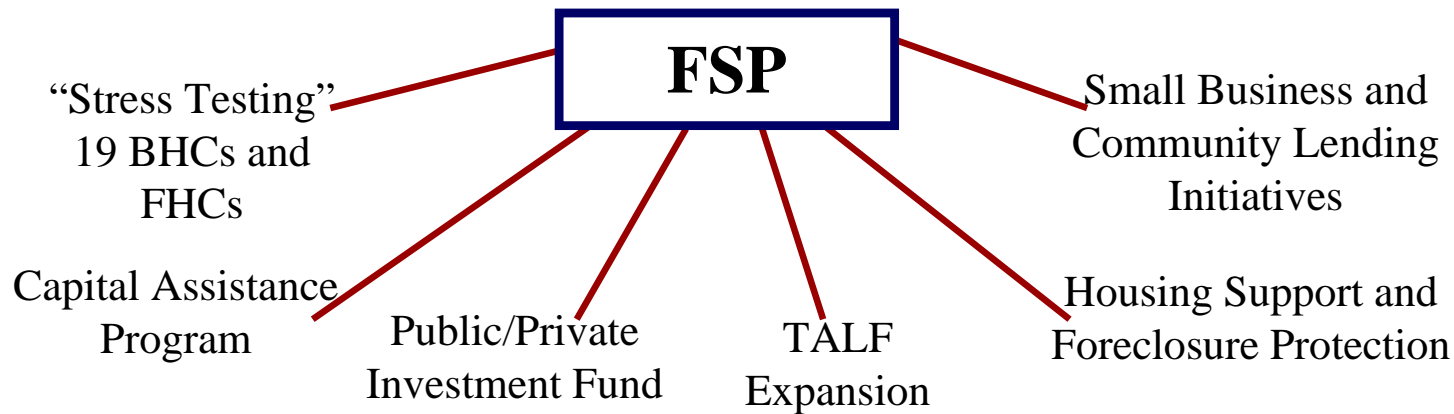
# Glossary of Terms

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<i>AB – Asset Backed (normally credit card, student loan and auto loan securities)</i>	<i>FSP – Financial Stability Plan of 2009</i>
<i>BHC – Bank Holding Company</i>	<i>GSE – Government Sponsored Equity</i>
<i>BV – Book Value, In the case of loans or securities, carrying value net of reserves</i>	<i>MBS – Mortgage-Backed Securities</i>
<i>CAP – The Capital Assistance Program of the FSP</i>	<i>OTTI – Other-Than-Temporary Impairment</i>
<i>CPP – The Capital Purchase Program under TARP</i>	<i>PEG – Private Equity Group</i>
<i>CMBS – Commercial Mortgage Backed Securities</i>	<i>PPIF – FSP’s Private Public Investment Fund Program</i>
<i>CDS – Credit Default Swap</i>	<i>SFAS 157 – GAAP fair value accounting</i>
<i>CRE – Commercial Real Estate</i>	<i>SPE – Special Purpose Entity</i>
<i>DCF – Discounted Cash Flow</i>	<i>TARP – Troubled Asset Relief Program</i>
<i>FHC – Financial Holding Company</i>	<i>TALF – Term Asset Backed Securities Loan Facility</i>
<i>FV – Fair Value – What a willing buyer would pay a willing seller at any point in time</i>	<i>TCE – Tangible Common Equity</i>
	<i>THC – Thrift Holding Company</i>
	<i>TRUPS – Trust Preferred Securities (usually pooled)</i>
	<i>UST – United States Treasury</i>

- ◆ On February 10, the UST announced a “plan for a plan” designed to deal with the banking crisis. The plan was long on concept and short on detail
- ◆ The key conceptual components of this preliminary plan were as follows:



- ◆ On March 23, the UST and FDIC provided detail on the Public Private Investment Fund. The PPIF has 2 components
  - Legacy Loan Program
  - Legacy Security Program
- ◆ Detail and our commentary with emphasis on community banks follows

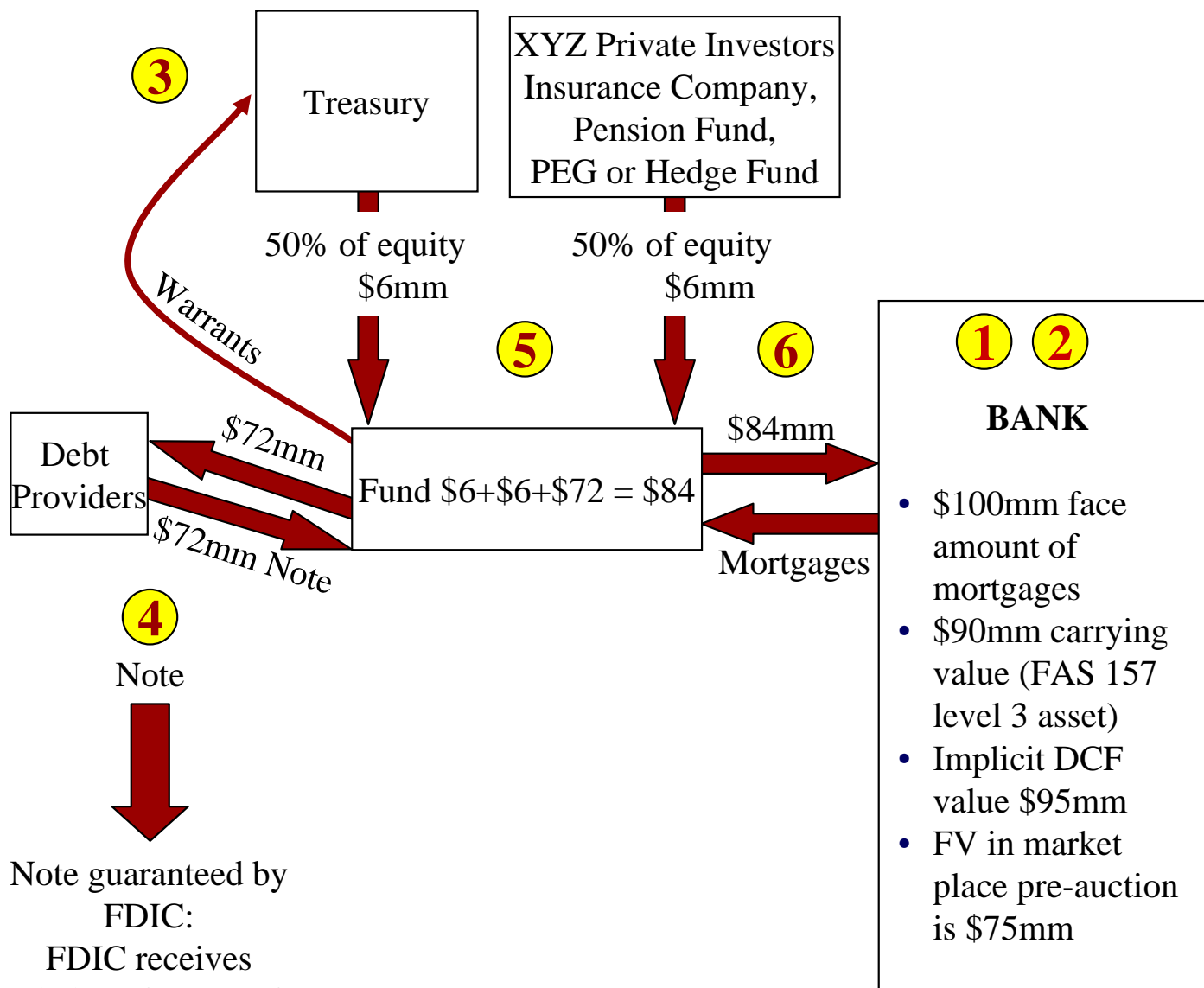
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# **Legacy Loan Program**

## **Examples, Diagrams and Comments**



# Legacy Loan Program – Example and Steps



**1**

- Bank approaches primary regulators and FDIC with \$100mm pool of eligible mortgages
- FDIC determines amount of leverage (up to 6 to 1) and elects 6 to 1

**2**

FDIC conducts auction – best bid is \$84mm by XYZ hedge fund at 6 to 1 leverage which is accepted by Bank with pre-established timeframe

**3**

XYZ and UST create single purpose Investment Fund; UST does not have control rights

**4**

Debt provider lends at 6 to 1 (\$84mm) and FDIC guarantees \$72mm

**5**

PEG and UST contribute \$6mm each; UST receives warrants of the Fund as required by law

**6**

Fund buys loan for \$84mm (cash or cash and debt) (less hold back to cover debt service)

Note guaranteed by FDIC:  
 FDIC receives pledge of 100% of purchased loans –  
 Recourse only against loans

# Legacy Loan Program – Sample Investment

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- Step 1:** If a bank has a pool of loans (presumably non-performing) with \$100mm face value (and a carrying value of \$90mm) which it seeks to divest, the bank would work with primary regulators to identify assets to sell and corresponding impact on bank from sale. After identifying, bank and regulators would approach the FDIC and would demonstrate to FDIC and UST the loan pool's quality based upon UST and FDIC agreed upon minimum requirements (TBD)
- The FDIC would determine, according to the process detailed on page 6, what level they would be willing to leverage the pool (assume the maximum 6-to-1 debt-to-equity ratio), oversee due diligence, prepare marketing materials and retain a third-party valuation firm to advise
- Steps 2&3:** The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bid from the private sector – in this example, \$84mm – would be the winner and would form a Public-Private Investment Fund with UST to purchase the pool of mortgages. The bank will have the option of accepting or rejecting the bid within a pre-established timeframe
- Step 4:** Of this \$84mm purchase price, the FDIC would provide guarantees for \$72mm of financing, leaving \$12mm of equity on a non-recourse basis
- Steps 5&6:** UST would then provide 50% of the equity funding required on a side-by-side basis with the investor. In this example, UST would invest approximately \$6mm, with the private investor contributing \$6mm and fund buys the loan. UST would also receive warrants in the Fund as required by law
- Step 7:** 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. Servicing would be provided by the bank, unless otherwise agreed
- Step 8:** The bank has a loss and capital hole of \$6mm (carrying value of \$90mm less sale price of \$84mm) rather than a loss and capital hole of \$15mm (carrying value of \$90mm less FV of \$75mm) if sold today outside of auction

- ◆ **Eligible Sellers** – Any FDIC insured US bank or thrift. No specialty lenders, hedge funds, etc.
- ◆ **Eligible Assets** – No detailed criteria yet proposed. Concept is that each bank work with primary regulator and FDIC to identify whole loans and securities that may qualify. Our guess is no derivatives. These assets would have to satisfy minimum requirements established by UST and FDIC
- ◆ **Eligible Private Investors** – Individuals, insurance companies, mutual funds, hedge funds, pension funds, banks, private equity funds, banks prequalified as eligible by FDIC. Concept is that they be “long term buy and hold” investors
- ◆ ***Leverage Determination*** – *FDIC will have a third party prepare an initial valuation based on expected cash flows. FDIC will use the valuation to determine leverage percentage*
- ◆ **Auction** – Conducted by FDIC; bidders cannot cooperate or join together once bidding commences. For a bid to be considered, it must be accompanied by a refundable cash deposit for 5% of bid value, which is refunded if unsuccessful. Process not yet detailed; a portion of proceeds of sale held back as debt service reserve fund
- ◆ **Loan** – Base amount set by coverage of FDIC Guarantee
- ◆ **FDIC Guarantee** – Determined base leverage ratio set by FDIC. FDIC guarantees 100% of P&I. FDIC gets pledge of sold loans. FDIC’s only recourse is to pledged loans

## Selling Banks

- ◆ How will the bank fill up the capital hole created by the sale of the assets at below carrying value if it is capital poor, especially in a bad economy? The public and private markets are not available to cover this spread
- ◆ *Will the leverage in the structure cause investors to bid above distressed/illiquid FV and get pricing closer to carrying values, which would decrease losses and capital holes?*
  - *If not, there is no benefit to the selling banks absent a capital infusion by the government*
- ◆ Will CAP be available to fill up the hole? In other words, will the “stress test” and “CAP” provision of FSP be coordinated with the PPIP program?
- ◆ Can the bank reject bids and withdraw assets or set a reserve in connection with bids to avoid unintended, forced losses? The answer is implicitly “yes,” but this very key point needs to be clarified
- ◆ What relevance would a failed or withdrawn bid have on assets?
  - Potential reclassification to held-for-sale? – We think “no”
  - New input for SFAS 157 fair value? – We think “yes”
- ◆ Can the bank retain an equity participation in the sold loans? The answer also appears to be “yes”
- ◆ What information about bank will FDIC make available to bidders to facilitate auction?
- ◆ What are the “minimum requirements” that assets must satisfy in order to be eligible for inclusion in auction process?
- ◆ Can an eligible bank buy assets from an ineligible seller (e.g., a hedge fund or private equity fund) and sell those assets in auction?

## **Executive Compensation Restrictions**

- ◆ If not a TARP participant, will selling assets into the PPIP program subject selling bank to TARP’s executive compensation limits?
  - According to Sheila Bair – “no”
- ◆ This appears to be consistent with UST analysis, as TARP “recipients” are required to issue warrants to UST

## **Investors**

- ◆ What limits and restrictions will be placed on fund managers in terms of asset management (buy, sell, securitize, hedge, etc.)?
- ◆ Passive investors are not subject to TARP executive compensation rules – but how about the general partner of the private fund? Probably, as they would be considered a TARP “recipient”
- ◆ What assurances do investors and managers have that Congress will not change the deal retroactively if the fund does well, especially in light of the extremely heavy government subsidies?

# Legacy Loan Program – Our Comments



- ◆ The rise in big bank stock prices tells us that based only on the UST’s released information, the market thinks PPIP Legacy Loan program is **GOOD FOR BANKS**. The reason:
  - The structure with massive federal subsidies encourages auctions which should result in substantially above FV market pricing perhaps geared to selling bank’s capital needs. According to a recent analysis in the Financial Times:
    - Assume a “toxic” loan asset with a par value of \$1mm has a 20% probability of producing \$1mm of NPV cash flows, and an 80% probability of producing only \$200m of NPV cash flows
    - A risk neutral bidder *using its own funds* would thus bid \$360mm for the assets – this is the true FMV of the assets
    - But if it enjoys a 90% subsidy (rounding by Financial Times – actual maximum leverage is 6:1, or 85.6% subsidy) on a non-recourse basis (this is key), the investor would be willing to pay \$714m for the asset (\$71m of the investor’s money and \$643m of the government’s money)
      - 20% of the time, the asset will produce \$1mm of NPV cash flows, generating investor profit of \$357m (\$1.0mm cash flows less \$643m loan)
      - 80% of the time, the asset will produce only \$200m of NPV cash flows, the investor loses \$71m, and the government loses \$443m (\$643m loan, less \$200m cash flows)
      - The investor has overpaid by \$354m (\$714m purchase price, less \$360m FMV) – this overpayment is being funded by the U.S. taxpayer
      - The beneficiary is the selling bank
    - *The structure thus has the effect of decreasing risk and increasing adjusted returns to investors thereby permitting them to bid more, minimize loss on sale of assets, and decrease capital holes created by asset sales at less than carrying values*
    - Thus the pre-auction valuation/leverage analysis by the FDIC becomes key to whether the program evolves or not. Assets cannot be sold at prices which will destabilize the selling bank. The price paid for the assets could be a function of the capital status of the seller
- ◆ As a result of this FV structure, the key to bidding from the perspective of investors is driven not by the FV of the assets, but by the probability of loss and the spread between the yield on the assets (per a DCF analysis) and the risk-adjusted cost of funds (UST equity and FDIC leverage). Thus, if assets are purchased at par and cumulative losses are 8-10%, ROI would be over 25%
- ◆ The pre-bid leverage determination by the FDIC should tell a bank everything it needs to know

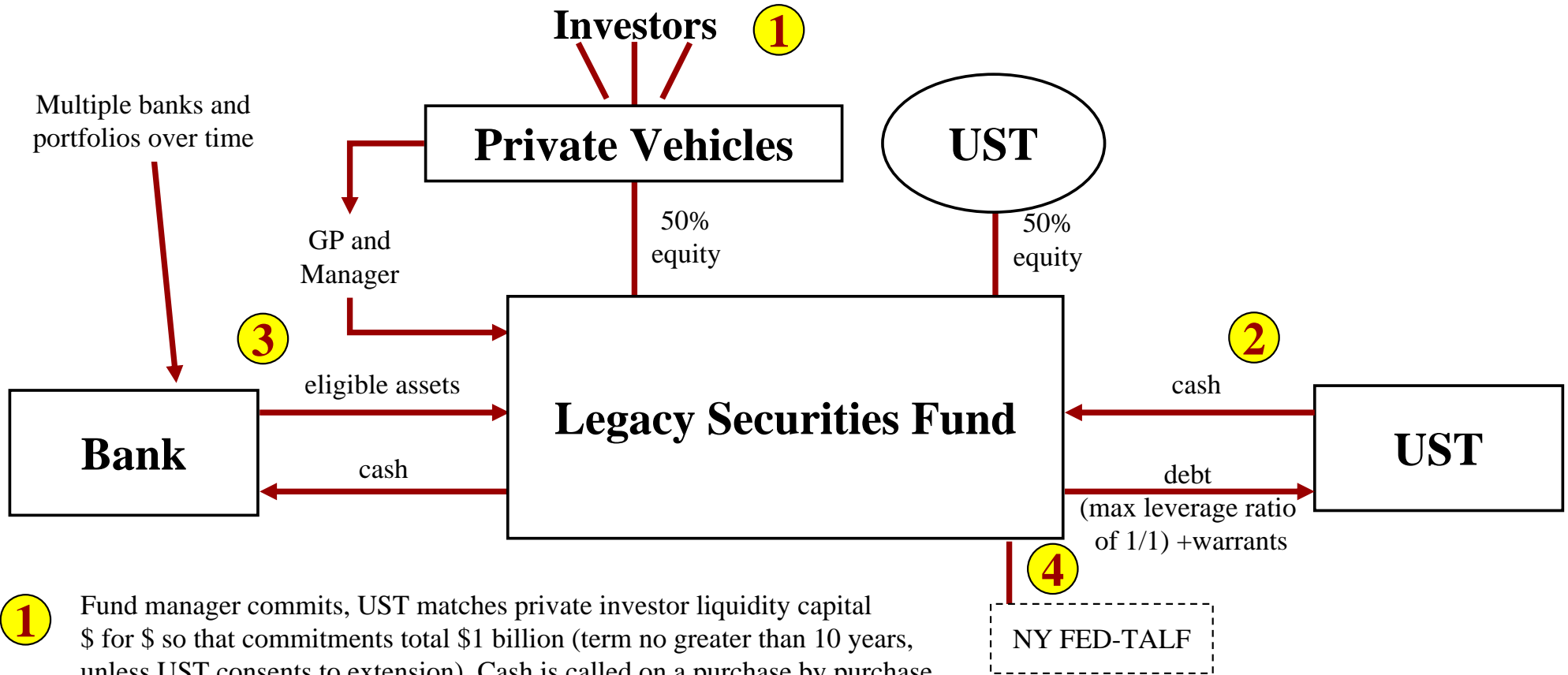
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# Legacy Securities Program



- ◆ The UST plans to designate 5 private sector fund managers to establish funds to buy mortgage backed securities
  - Possess or have ability to raise \$500mm of private capital
  - Minimum of \$50 billion under management
  - Headquartered in U.S.
- ◆ Eligible Sellers
  - Financial institutions broadly defined, including banks and thrifts
- ◆ Eligible Assets
  - Commercial or residential mortgage-backed securities issued before January 1, 2009 and *originally* rated AAA and secured by loans
  - Purchased solely from financial institutions
  - CDOs and synthetic products are not eligible
- ◆ Multi-investment structure (unlike Legacy Loan Program, banks, private investors, and the Treasury)

# Legacy Securities Program



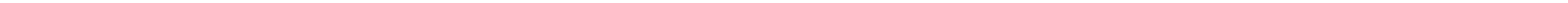
- 1 Fund manager commits, UST matches private investor liquidity capital \$ for \$ so that commitments total \$1 billion (term no greater than 10 years, unless UST consents to extension). Cash is called on a purchase by purchase, investment by investment basis
- 2 UST commits to loan, with recourse limited only to purchased assets up to 100% of Fund's equity (subject to restrictions on fund) or another \$1 billion so that Fund now has 1:1 leverage and \$2 billion of purchasing power
- 3 Fund purchases CMBS and MBS from banks or other eligible sellers and draws pro-rata on UST private party equity and UST debt to fund each equity purchase
- 4 Borrow money from TALF, which could increase leverage potentially to 2:1, which would result in \$3 billion of purchasing power

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## **Our Take: PPIP**



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- ◆ *The question – will the bids be high enough to mitigate losses and capital holes?*
- ◆ *Heavily government subsidized structures say the answer should be “YES”. This is especially the case in the PPIP Legacy Loan program if FDIC pre-auction valuation assures enough leverage to dictate this result. 6 to 1 leverage goes a long way to create the potential for more than acceptable private equity and hedge fund risk adjusted returns*
  - Both programs should work better with assets which have been marked to market (smaller capital hole to fill) – the sale should de-risk selling bank’s balance sheet and may even result in a gain – both very welcome results
  - The Legacy Loan program is especially valuable if selling banks know the amount of the bids and have the opportunity to pull away if bids not high enough to mitigate losses and the level of the capital hole

- ◆ Capital through FSP’s CAP program is available from UST, but the ticket for admission is a stress test and executive compensation restrictions. We think that UST wants to minimize future direct investment in order to avoid going back to Congress for more TARP funding – a way to do this is by the UST using leverage
- ◆ **IF** a bank can de-risk its balance sheet
  - Higher valuations should result in short term
  - Investor interest should return in the longer term
- ◆ Investors will have to get comfortable with the government as a partner – our bet is they will because the leveraged returns will look so good.
- ◆ We wonder how Congress will view the heavily subsidized structures and whether they will view it as another bailout of the banks or a “windfall” to investors or both?

**We think community banks should evaluate these programs against their particular risk and capital profiles and discuss the possibility of participation with primary regulators and the FDIC**

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## About Griffin

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*[www.go2griffin.com](http://www.go2griffin.com)*



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- ◆ Our Griffin Financial Institutions Group is part of an integrated professional services firm consisting of:
  - A FINRA licensed investment bank focusing on the financial services sector
  - A full service AmLaw 200 law firm focusing on the financial services sector
  - An SEC registered money manager focusing on the community bank sub-sector, with exceptional sector insights and exceptional track record
  - A private equity placement and due diligence business which understands the intersection between the financial institutions and private equity sectors
  - A D&O and E&O insurance risk consulting business focusing on the financial institutions sector
  - A tax consulting business which assists financial institutions manage its tax provision
  - Strong federal and state government affairs and several other businesses which focus on financial institutions and complement and expand our platform

# Our Platform – How We Are Different

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- ◆ Our Griffin Platform consists of over 240 multidisciplinary professionals covering the Northeastern U.S. from 17 offices
  - Our platform stresses the value of occupational and educational diversity and sector experience
  - In addition to sector experienced investment bankers, lawyers, placement agents, government affairs and investment professionals, our team members include former senior executive officers, accountants, tax professionals, risk managers, regulatory compliance officers, economists, swap advisors, and research analysts
    - *The inclusion of in-house, industry specific financial accounting and tax capabilities in Griffin is unique among investment banks specializing in the financial institutions sector*
- ◆ Our Griffin Platform stresses the value of understanding sector needs from its clients' perspective
  - Our staff includes many former senior executive officers of both large and small depository institutions, specialty lenders and others in the sector with hands-on operating and transactional experience
    - *Our professionals have managed and built both small multi-billion institutions growing them organically as well as via acquisition and then selling them. These capabilities are in addition to those of any other investment bank which generally lack professionals with any meaningful operating experience in the sector*
- ◆ Our Griffin platform also consists of transactional professionals with broad and deep and best of class bank and thrift experience comparable to or better than any of its competitors
- ◆ Our sector experience coupled with our occupational and educational diversity, multi-disciplinary approach and experienced transaction professionals combine to deliver exceptional value to our clients



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