Will PPIP Do More Than Squeak?

The Public-Private Investment Program is Washington's latest attempt to help shift troubled loans and securities. Prices for many assets rallied since its announcement. But details are still being hammered out months later. Meanwhile, the government stress tests of the top 19 U.S. banks may dissuade one of the largest groups of holders from selling. And Congress's penchant for imposing retroactive restrictions on firms that received taxpayer-funded Tarp capital has made many potential buyers gun-shy. Our panel of experts gathered in May to discuss the whys and wherefores of the program.

The Panel:

The Moderator

Antony Currie — American Securitization

The Investors

Ralph Daloisio — Natixis
Denise Crowley — Zais Group
Richard D'Albert — Seer Capital

The Bank Portfolio Manager

Jon Bottorff — HSBC Finance

The Lawyers

Michael Gambro — Cadwalader Wickersham & Taft
Jason Kravitt — Mayer Brown
Steven Kudenholdt — Sonnenschein Nath & Rosenthal

Antony Currie: Update us on the progress of the Public Private Investment Program. Is it taking longer than expected to implement?

Jon Bottorff: I don't think it's taken too long. There's a clear understanding that the next step, under PPIP, needed a lot more clarity than earlier trial balloons that caused a lot of confusion as far as what the rules were. But the almost intense silence in the last month has made a number of people almost forget about it. Before this roundtable, I had to review my notes because I couldn't remember all the details of the proposed programs. And no one's been talking about it on the Street recently.But what the market really needs is that, when the government finally delivers something, it does so in full, with all the roles and with a comment period, and then we can get going.

In the meantime, we're all twiddling our thumbs waiting and conducting what business we can.

Jason Kravitt: I would like to put this into perspective. I have worked on several rescues now — not a role I originally envisioned for myself — and it's incredible how complicated everything is, how many constituencies you have to take into consideration and how long it takes to get it right. The nature of the structured finance industry is utterly detail oriented. It's not just the devil in the details. God is in the details too. And some of the rescues I've worked on have failed because they took too long and people figured out ways to solve their own problems. The PPIP is also going to take much longer than the government plans or wants, and when they come out with their proposed regulations, they're going to be surprised at the volume of comments they get, because it's so hard to get it right.

The fact it's taking so long is characteristic of trying to produce programs in this market. We'll all have to work in an extraordinarily efficient fashion with some emotion for it to work on a time frame that will do the most good. If you took the top hundred structured finance and private equity professionals in the U.S. and told them to write this, it would take them several months and they wouldn't get it right. It's very hard.

Michael Gambro: I agree that there are going to be a lot of details that are going to be very difficult to work through. But it may be too little, too late. I wish they had started when Tarp was first enacted. It would have had a bigger impact than it's going to have. And by now we would have something in place that would make sense.

Richard D'Albert: Think about the amount of time that it took for us to enact the Talf program. That's a relatively simple program, by comparison to PPIP. From the initial announcement to when it subsequently rolled out in the first and second iteration, and after we had worked out a lot of the logistics, it was at least four months. As regards PPIP, no doubt they will put out a program which will inspire a great deal of commentary — all of it constructive. But it will take a significant amount of time before a lot of the details get worked out.

Meanwhile, you have a market poised for optimism. There's been a tremendous rally for structured paper, largely in anticipation of PPIP and the expansion of Talf. So there is a risk of disappointment that's built into the market.

Steve Kudenholdt: Hopefully it will turn out to be a bit like the Home Affordable Mortgage Modification program: that had a quiet period after the conceptual guidelines were released. But once the actual directives and operative agreements came out, it became clear that there was enough detail on the table to see it moving forward.

The problem here is that all we have are just term sheets that are a few months old and the appearance of no momentum. I'm sure a lot more has been more going on behind the scenes, particularly at Treasury, than people are aware of. It's probably primarily focused around selecting the managers for the Legacy Securities Program. But it could well be that soon appearing in an in-box near you will be something with some real meat on it.

Ralph Daloisio: There is tangible progress. They just announced parameters for the legacy CMBS Talf. Granted that's Talf and not necessarily PPIP, but it looks like there's going to be an intersection in the ability of the PPIP funds that are being created to actually finance assets through Talf. There's a fairly ambitious coordination process between the different legs of the program, some being operated by the Fed, others by the Treasury. As for timing, it all depends on perspective. On one hand, PPIP is doing what Tarp was originally intended to do. By the time the first dollar actually gets funded under PPIP, we may well be in the autumn of this year, which would be close to the anniversary of Tarp.

On the other hand, the government, through its policy philosophy, ended up having to put in place so many different programs almost simultaneously that invariably they created a logjam of execution for themselves. We're at the stage now where we're going to start seeing this accelerate, but the aid is accelerating into markets that have largely started to rally on their own over the past month or so.

Denise Crowley: One reason for the rally is that the market recognizes the government's desire to help fix the problem, to do what it takes to get people to the table and to use Tarp, Talf and PPIP financing. In so doing, they've eliminated a lot of the tail risk, or at least the market's perceived view of tail risk.

It's just going to take some time to get all of those details in place. Keep in mind this is going to be very much an iterative process. Talf, as applied to new issues, was much altered along the course, from customer agreement changes to changes in overriding agreements governing the whole program. PPIP is likely to be very similar, after a lot of comments coming back from investors.

Antony Currie: Jason, Ralph touched on an interesting point, especially for someone like you who has worked on a number of rescue packages: that markets come up with their own solutions because government aid is so slow in coming. Which means perhaps that merely the announcement of a rescue package is all that's needed— at least it seems to spur participants to action. M-LEC,

the so-called super-SIV, seems to be a case in point.

Jason Kravitt: Well, just for the record, M-LEC ran out of time. But that was the first experiment with putting together a vehicle to try and rescue a market. I've since worked on Straight-A Funding and the people who designed that really learned a lot from M-LEC: Straight-A did close on time and will rescue its market. But it took a long time and it took a lot of tinkering.

I don't think there's any general rule for enacting such intervention. In M-LEC's case the crisis got so bad that the market just couldn't wait for the rescue. But had it waited, the parties involved would have done better, I believe.

Mayer Brown's Jason Kravitt

The rescue that was designed in M-LEC would have left the SIVs and their sponsors better off than the remedies that they took, which was to take everything on the balance sheet and to create a further pressure of downward price movement because of a lot of supply and very little demand.

The well-designed and well-executed rescues have a very positive role to play. They're not set up with the idea that in the meantime the industry is going to solve its own problems. There are genuine attempts to solve the problems. Sometimes they succeed, sometimes they don't have enough time to succeed.

Michael Gambro: I'm wondering if we're talking about different markets when we're talking about rallies. Yes, there has been a rally in CMBS pricing, but you're talking about bonds that were priced with a yield of 25% and are now at 15%. But it doesn't lead to new lending at levels that borrowers feel like they're going to be able to support. I have recently gotten calls, as a result of Talf and its application to CMBS, about financial institutions perhaps getting back into the business, making conservative real estate loans for CMBS take-out with Talf take-out. They're very much concerned about warehousing risk. But there's still a lot more to happen.

Steve Kudenholdt: We've noticed that, too. There's a long way to go, and of course nothing has been done yet for non-GSE-eligible residential mortgage loans. I saw some startling figures for residential properties in excess of GSE thresholds: the inventory is now 40 months, as opposed to the standard markets, which are now going from 11 to nine months or so.

Antony Currie: Banks are saying to you that they're willing to lend more because of Talf? Have they quantified that at all, or it's just a general feeling on their part that they might be more willing to lend?

Steve Kudenholdt: It's more than a feeling. Banks are starting to develop programs and issuance term sheets for commercial mortgages in anticipation of some actual origination starting soon.

Steve Kudenholdt of Sonnenschein

Jason Kravitt: I might be wrong, but this whole phenomenon has revealed to me, at least, how much economics relates to psychology. It's fascinating how we went into the summer of 2007 fat and sassy, just sure that everything was going to work. Everybody thought that things were just going to keep going the way they were, and within just a few months everybody's attitude changed to expect the worst out of everything. I agree with the people who've said we don't have a credit crisis, we have a trust crisis, that nobody trusts anybody anymore or trusts valuations or trusts prices, that the real strike was that banks wouldn't lend to each other, not to consumers or their customers.

And you can feel that people think that we may not be at the bottom of the U, but that we're approaching the bottom of the U and that there's light in the tunnel. There are too many variables to control how this happens, but it seems as though psychologically people are beginning to see the positive side of things. You could have taken the announcement for PPIP and said: "Wow, that's just a bunch of shit, you know, why is this going to succeed?" Or you could have brought the attitude to it that: "Well, that's a good outline. It needs a lot of work, but there is something there." People are bringing an optimism now to proposals that a year ago they wouldn't have,

Richard D'Albert: I think that optimism is a little fragile. To Michael's point, we are talking about different markets. The bond markets have rallied, whereas real estate and asset prices haven't necessarily responded, but they're all related. And the pricing that you're seeing right now in the bond market is driven by expectations of leverage being provided through Talf and PPIP. To the extent that that doesn't materialize in a way that the market expects, there will be a subsequent sell-off, and you'll see a reversal in that optimism.

Jon Bottorff: Whole loan pricing in the mortgage markets for non-GSE-eligible paper has certainly not followed the rally in the bond market. I watch that market and sell into it occasionally, and what happened was a bit of a firming of pricing and a halt to falling prices once PPIP for legacy loans was announced. But it has pretty much stayed flat and hasn't really reacted to anything else.

The interesting dynamic is that Talf is continuing to improve and develop improved psychology as well as improved pricing. If, for some reason, the legacy securities program doesn't prove to be as successful as we hoped, Talf is successful enough that I'm not sure that the psychology and the pricing would fall away. But that's not true for the home loan market. That's the one area where people are still waiting for something to happen.

Denise Crowley: Clearly the market has reacted to the potential magnitude of the program. Think about how much money had been raised for distressed funds to buy legacy loans or securities. It's a relatively small amount. I've seen all different kinds of estimates, but the highest estimate I've seen is probably $40 billion or so. It's unlevered, there really is no leverage available and that $40 billion-ish is requiring a 15% return, or more. Part of investors' strong reaction to PPIP has been the fact that the amount of purchasing power it allows you to create is potentially huge relative to the size of the market.

The market value of triple-A RMBS and CMBS securities is probably $1 trillion-ish at this point, and the potential purchasing power on the securities side is probably half that. So, this is a massive increase in potential power. Clearly, there are a lot of details to be worked out and there are a lot of things that can derail this purchasing power. But that is in large part why so many of these securities have rallied. There are other issues — like banks re-REMICing assets — but clearly the overwhelming size of the program is potentially tremendous, especially for securities.

Jason Kravitt: Is anybody a little bothered by the amount of leverage that's being put into the solution to solve the problem, which was excess leverage? I'm a lawyer, not a banker, but I feel a little uneasy about the Fed and the Treasury using tremendous leverage.

Denise Crowley: Clearly you're giving some leverage to a market that is accustomed to leverage. The issue here is that the leverage is muted relative to the amount we used to be able to put on these assets. One turn of leverage via PPIP and then maybe some additional leverage via Talf, and depending on

the securities haircuts let's just use a round number of four or five times leverage. That is much less leverage than the levels to which these assets used to be levered, And the way in which the government has structured Talf thus far, both for primary issuance as well as for legacy CMBS, is actually a nice balance and the leverage much more reasonable.

Jason Kravitt: Let me make sure I understand: the PPIP leverage is up to six to one, which is really 13 to one?

Denise Crowley: On the loan side, you can likely get leverage of six to one.

Jason Kravitt: Right, but say you're leveraging securities and you use PPIP to purchase under Talf, is the leverage that you get up to four or five to one? Or can it be higher?

Denise Crowley: We don't know precisely yet because we don't know exactly what the haircuts are going to be, particularly on RMBS. We have a lot more clarity now on CMBS. So we don't know 100%, but you're certainly not going to get 10 times leverage. Remember, these are the same assets, the triple-As of RMBS and CMBS, that were levered a hundred times in CDOs and SIVs in the past. Now you're talking six turns of leverage on these assets, and it looks like, as per the CMBS legacy guidelines, it's going to be leverage on a par notional basis, not on a dollar price basis. That mutes the leverage impact as well.

Michael Gambro: If you look at the report by Tarp Special Inspector Neil Barofsky, he focuses precisely on Jason's question about the amount of leverage provided by the government and the opportunity for abuse that leverage creates. In his view, the opportunity for abuse is enhanced by the small amount of skin in the game on the legacy securities program that might exist through leveraging through the Treasury and then leveraging through Talf.

Steve Kudenholdt: Leverage is essential, though, at some level, or else we'll all be going back to a cash society. There's a right level of leverage which is consistent with equity returns but also with a stable environment and stable pricing of assets. An 80% loan-to-value on residential real estate in a stable market is pretty conservative and it's not dependent on price increases to recover the debt. But at 95% or 100% or 125% LTV, it is dependent on a rising market and facilitates a rising market. And the leverage at the major non-bank investment banks was, at the 30-to-one level, way higher than the 8% capital that a bank would have, which drove so many of these assets out of banks and into non-regulated companies and vehicles.

Cadwalader's Michael Gambro

The FDIC legacy loan maximum leverage is quite conservative. And it will be dialed down for riskier assets. The legacy CMBS haircuts under Talf are pretty stiff at 15% to 20% of the par amount and that is the amount that is taken off the actual purchase price.

Antony Currie: Is leverage the issue, though? Or is pricing the assets the more crucial point?

Richard D'Albert: The leverage is key to defining equity returns and therefore key to establishing what people are willing to pay for those assets. There was a recent study that compared the price of the Talf financing and its impact on spreads versus the degree of leverage that was provided by Talf. By an order of magnitude, the amount of leverage implied a far greater impact on spreads than whether Treasury priced Talf financing at Libor plus one, Libor plus two, or whatever. So I do think the degree of leverage is significant in defining asset prices and inflating the value of these so-called toxic assets.

Denise Crowley: You also have to look at the profile of the assets that are being levered. For legacy CMBS, at least, we're really talking about super senior triple-As, which typically have 30% credit enhancement. Applying leverage to assets that are essentially the top 70% of a capital structure that are very likely to ultimately be money good, or close to it, is a very different proposition than levering binary assets. Eliminating the more subordinate classes of securities does provide some comfort. I'm not suggesting that every triple-A should be levered to the max, but the profile of the underlying cash flows can support this type of modest leverage, in general.

Ralph Daloisio: It is somewhat ironic that the solution was also what caused the problem. And so, yes, the remedy is very much the old saw, the hair of the dog that bit you. But it's a necessary remedy because our system was very dependent on leverage and we couldn't de-lever that quickly without having experienced an even worse crisis than we have.

So at a very basic level, what took place here was a substitution of the government's balance sheet or, if you will, the taxpayers' balance sheet, for the private sector balance sheet. And that was needed because we were operating in an environment where the Fed was driving government rates down, and while they were doing that credit rates were exploding. That left us in the situation where the actual cost of borrowing had nothing to do with the government's yield curve or Fed monetary policy, but with the fact that there was a lot of fear over a domino effect of counterparty defaults and a lot of fear over fundamental issues, like just how solvent are these borrowers, and also concern that as leverage was being withdrawn from the system, the refinancing risk being introduced would cause system-wide failures.

So what the government did made all the sense in the world to me. If the private sector is clearing in the double digits and the government is borrowing beneath 1% on the short end of the curve, it said, okay, we need to bridge this gap for some indefinite period of time until we can stabilize the system. The prices in the system adjusted so that clearing levels were producing these 20%-ish types of unlevered returns, meaning you didn't need any additional turns of leverage to get your equity provider a very attractive return on that equity, but who can afford to pay 20% on their money without going broke?

In effect the taxpayer became the leverage provider to prevent a systemic collapse. However, the basic proposition to the U.S. taxpayer is probably suboptimal, because if you went to everyone in the U.S. and said: "I'm here to collect some money. I'm going to give it to the government, and they're going to run an investment program for you," they might say: "Well, the government already runs one for me. It's called Social Security, and based on how that one is working, I don't need another, thank you."

When we look at how much leverage was needed and where that leverage was coming from, it makes a whole lot of sense that we've gotten to where we are. I'm not sure we needed all these different programs to achieve that, though.

Jon Bottorff: I've been thinking about leverage less in terms of whether I'm happy with the current leverage, because I guess I am, but more in terms of what's it going to mean in, say, five years' time. Right now we're going to have government programs that are going to mandate leverage issues for a period of time. They're going to unwind those programs and they're going to stop. Will that automatically be the new market-based leverage that banks would be willing to provide in the future as they step in for the government? If not, what's that going to do to prices of the assets that I might own now?

Michael Gambro: Hopefully they will step in.

Antony Currie: There's concern about the market being like a heroin addict going cold turkey?

Jon Bottorff: That's my concern. So is there another bump as the government tries to disengage from what's really a massive substitution as the bank of last resort for all of us.

Steve Kudenholdt: There would certainly have to be a rise in prevailing interest rates. It looks like it will be a two-step process: first the government issues or backs debt to allow the financial institutions to earn their way out of their loss positions. Once that's been achieved and the banks are stabilized, and to the extent that from that point forward everything is not funded or backstopped by the federal government, market participants are going to

demand higher rates.

Hopefully the recovery from this mega recession is far enough along that we can all withstand and live in a rising interest rate environment. But it would seem to be inevitable.

Denise Crowley: That's exactly the calculation that investors are largely doing today when looking at PPIP and Talf. They're looking at the refinancing risk, the risk at the end of the term of the investment. Investors are going to make pretty wise decisions overall, picking assets that are likely to yield enough cash during the, say, five-year or so period that you would have on legacy assets under Talf and PPIP so that they will have recouped a significant portion of the money that they invest by the end of that term.

There have already been pretty big bifurcations in the pricing of securities that are probably more leverageable and are likely to give you higher cash on cash than the securities that are not, in part caused by this exact scenario.

I have to say I was fairly impressed with the government's handling of that as it pertains to legacy CMBS. They have allowed a cash on cash that gets investors almost whole, almost to a zero IRR within the five-year term — and likely beyond that if you include the compounding interest on their reinvestment of the capital they get back along the way. But to actually make a lot of money, investors have to repay the debt, which is a very interesting dynamic.

Antony Currie: So only the better assets are bought? Doesn't that, in part at least, defeat the purpose of trying to free banks of their problem assets? And doesn't that imply that the more likely sellers are going to be those institutions that don't actually need to sell?

Jason Kravitt: Who is going to be motivated to sell and at what price will be fascinating to watch. Accounting will have a lot to do with that. Before FASB adjusted last month the

HSBC Finance's Jon Bottorff

accounting rule on what aspect of a write-off you had to take into income and capital, there was a much bigger motivation for banks to sell their assets. An asset may have started out at a book value of 100 and gone down to 40. Because they had gotten so low, they could probably sell them at a price that not only would not further write them down but might even give them some income to recognize — and they would forever have eliminated any future losses on those assets. But now, conceivably, something that you had written down to 40 really is only an 80, because only 20 was allocated to credit losses, and of the 60 write-down, 40 was supply and demand related. So the motivation to sell might have disappeared in a lot of cases.

On the other hand, banks that bought companies that had big failing portfolios may have written everything down, period, already, and so they can sell. Those also are probably the banks who the third factor is important to: that's the extent to which government puts pressure on banks to sell. Those that still hold Tarp capital are not going to be completely free of government influence, may have to be sellers and they may not be selling their best assets. They may be selling the assets that everybody was afraid of.

By the way, I think that Tarp should have done the toxic assets first to enable the government to figure out which banks to put money in and for how much, because part of the trust problem for the first nine months, or maybe the first 12 months, was that nobody knew how much money a bank needed to be good. Maybe $25 billion wasn't good enough, because you just didn't know about their assets. If the PPIP is successful, we'll know a lot more about bank assets, we'll have started to price assets, and then you can make much more rational decisions on how much capital banks do or don't need.

Antony Currie: That's chicken and egg, though, isn't it? To sell or guarantee assets at that stage would have required immediately boosting banks' capital. But as we have seen, constructing a way to price the assets has taken nine months — just finalizing Citi's asset guarantee alone took around three months. But that would have killed a lot more banks last Fall as the markets were in no mood to give them three days, let alone months. And now the stress tests of the 19 largest institutions, holding three-quarters of the assets in U.S. banks, ought to have reduced their desire to participate in PPIP, surely: why sell assets when your regulators have just made sure you have two years of capital to absorb expected losses already?

Jason Kravitt: I would have started out with a good bank, bad bank. I think that would have gotten around the capital problem.

Steve Kudenholdt: One really sensible way to utilize legacy loans would be to set up a test case as part of a bank insolvency: take a bank, let's say not within the top 19, but one with some troubled assets that are not really sellable or financeable. The government takes over the bank, cleans it up to make it an attractive takeover target, perhaps not even on an assisted basis, and then finds a home for the unwanted assets at the right price by providing FDIC-guaranteed financing for them.

Zais Group's Denise Crowley, and Michael Gambro

That would be a very sensible way to use legacy loans.

Denise Crowley: That's exactly what we expect to happen to a lot of these banks where the situation is murkier than those that have undergone the stress tests. They're currently not failed institutions, but are somewhat likely to fail, and we see PPIP, particularly as it pertains to loans, as one tool in the government's arsenal right now.

Most of these loans are not marked anywhere close to where they would likely trade and so, sure, if there's a failed institution and the FDIC wants to negotiate a sale of the assets of that failed institution, that is one way in which managers of PPIP could get involved in buying loans. There's probably significant demand from asset managers to buy the loans without government partnership, without government equity, and I think that there are many investors out there who would like to potentially buy loans and simply get the leverage, and so we'll see how that shapes up.

Richard D'Albert: The concern people have as to whether or not you're going to have a willing seller for PPIP is often framed in the context of the largest financial institutions in the country. Clearly the motivation there has been lessened by changes in FASB and the stress tests clarifying the amount of equity that needs to be raised. And the banks, going out and raising a substantial amount of that equity now means that they're not as compelled to sell these toxic assets as they were.

But you can also think about PPIP in the context of all the institutions that are not within that top echelon and other institutions that will go through receivership. PPIP and the legacy loan program are, as Denise mentioned, tools that the government can use, like they did with IndyMac, to liquidate assets in an efficient way and from the standpoint of the taxpayer in an efficient manner almost like RTC II.

Antony Currie: Denise, I want to go back to the point you made about investors looking to buy assets without using capital from the government, but just leverage. Would that be a good deal for taxpayers? They would get no upside in that, just clip coupons and with luck get their debt paid back.

Denise Crowley: You'd have to structure it in a way that protects taxpayers. Who knows if they're going to get there or not, and who knows if the government even wants to lend in a Talf-like way without having the co-equity investment? But back to the CMBS legacy securities program again, they were at least thinking about the put that they would implicitly be long had they not capped cash on cash on those securities. The government is in a better position if they co-invest with regular private investors and get more protection that way. It's too early to tell if they will be able to come up with another structure that might mitigate the back-end risk.

Jon Bottorff: The desire to have the government as a partner is not high on investors' lists, but their desire to take the government's money as leverage is relatively high, as long as it doesn't come with any shackles.

We would get a lot more volume if the government just provided leverage, but the reality is it's not going to happen. From a political standpoint, if investors want to participate in this, they're going to have to share it: the government has already made a major point that the taxpayer is going to be able to share in whatever the upside is, because there's an immense fear that the investor would simply under-price. I'm not so sure that's a well-founded fear, because sellers won't sell at an undervalued price.

As for the willingness to sell, the proof will be in the pudding. Something tells me that there will be more selling in there than a lot of people think, even with the stress tests. The government will put pressure on some of these institutions to seed this program and get it going so that a lot of people on the periphery who won't want to be the first out of the trap will begin to participate, though maybe not in the size that we want.

Crowley, Gambro and Kudenholdt

A good example right now is on the Legacy Loan Program. Foreign-owned banks, including mine, aren't allowed to be in it. The Institute of International Bankers sent a letter, because we want to be included on the same playing field. It's not necessarily that I have something identified that I want to sell. I just want to be on the same playing field so that, as I watch the market develop, we can take a sliver here or a sliver there or at least have it as an option. The point is that as things develop, you will find more people maybe playing that option of saying: "Look, I've got this legacy portfolio and I would like to see that wind down a little faster than it's going to do on its own, so let's just sell a little bit, take a little bit of pain."

So you may see some more selling — not gigantic numbers from individual institutions, but I'm guessing you will see a broader array of selling over time than many of us expect. That's a guess.

Antony Currie: Let's turn to Congressional actions of recent months, not least, the retroactive measures imposed on those receiving government funds. Has the fear and consternation that provoked died down?

Ralph Daloisio: Early into this Administration's approach to our financial markets, I was becoming concerned that maybe we were operating only with two branches of government, since there seemed to be such an alignment between Congress and the Administration on some key issues. I also felt that the economic partnership propositions were akin to looking for and getting $1 from the government, but having that come with maybe $5-worth of strings attached to it — some defined, some perhaps to be defined at some later date as the wisdom in D.C. saw fit. But that has subsided and we're starting to see some specific carve-outs. In the PPIP program, for example, it's explicitly written in now that as long as investors are passive and as long as the asset managers are acting as institutions and not as individuals, they won't be subject to these executive compensation restrictions.

Interestingly, what may have checked the power of D.C. could very well have been their own recognition of just how powerful they were becoming, and that used in a less than judicious way it could be very counterproductive to the goals that they were setting for themselves. So it's less of a concern, but partly because we are shifting from a more pessimistic psychology to at least a more neutral, if not optimistic, one. However, if we start going back the other way, who knows what could manifest itself? So it's a bit of a wild card that I don't think anyone can quantify, although they all want to cautiously discount it.

Michael Gambro: I somewhat disagree with that, based on conversations that I've had with non-Tarp recipients. They continue to be concerned with the lack of regulatory clarity coming from Washington vis-à-vis executive compensation and other issues. There's the whole congressional sovereign risk issue that you just have to live with, or not. But there's a real regulatory concern about whether or not the executive compensation provisions are going to apply to the fund managers. And definitionally there are concerns — what is a passive investor, exactly, for example? Some are saying they don't want a term sheet, they want to see it go through the regulatory process so they have clarity.

Jason Kravitt: I would state it even more strongly. What's happened in this mega recession is that some things are changed for generations.

Natixis's Ralph Daloisio, Kravitt, Bottorff and Seer Capital's Richard D'Albert

For example, it's hard to see how, in this generation, attitudes towards ratings agencies will ever be quite the same. Other institutions that have suffered — not our regulators, because they've uniformly been honorable, consistent and constructive, at least the ones that I've dealt with. But Congress has varied in its attitude so much and felt so free to change the deal that it struck that for at least a generation there will be distrust of programs that Congress can affect, and that will literally go into pricing. Everything will be more expensive, because the U.S. is not as different from the rest of the world as it once was in terms of fear that the government can change the game.

Steve Kudenholdt: Worry about rule changing is what I hear most frequently from investors, especially. Prior to this crisis, not having the government as owners of major private corporations was a bedrock concept — we don't want management, economic and financial decisions being made for political reasons.

But the government is a unique counterparty. It can print money and can change the rules, and politicians are required to listen to what their constituents say. Maybe it's relearning a lesson that was learned long ago, but Jason's right: it will stick with people for a long time.

The one thing that would be helpful would be if there could be more regulatory clarity on things like having no intention of imposing punitive taxes on windfall profits. Or make it clear

Daloisio and Kravitt

one way or the other. The government could even build it into the deal, saying: "All right, we're not going to co-invest, but here's how we are going to get our upside. We're going to have an equity kicker on some percentage of your profits," and that's the deal.

Denise Crowley: Retroactive taxation is much more obvious, and you could clearly apply that to anybody. But the whole concept of pay caps as it applies to employees of private companies who have never taken a dollar of government money via Tarp, it strikes me as an unworkable concept.

Jon Bottorff: One of the things still hanging out there, though, is while it's clear that they don't want to cap executive comp at the asset managers and investors, it's absolutely not clear what they're going to do for the selling banks. They want to have as much active participation in PPIP and Talf by small banks, regional banks and large banks. If they say that the executive comp provisions are applicable to participating selling banks, then it's going to cause a massive withdrawal from the program.

Denise Crowley: The Treasury made some more announcements and they were relatively silent on whether or not the pay caps were going to apply to asset managers. I don't know if it was an oversight, but in this environment I wouldn't suggest that it is.

We did get some point of clarification in S.896, the legislation that recently passed, regarding PPIPs. There are some pretty burdensome things that PPIP managers will have to deal with, like disclosing their top 10 positions, disclosing all of their investors if it's a new fund or the investors owning over 10% if it's an existing fund, and having a lot of reporting duty and establishing conflict of interest rules. I suspect most of the large asset managers have conflict of interest rules in place, but nonetheless the burden is considerable. Then factor in having to deal with the special inspectors general and making sure you're compliant with all that they want. It could be significant incremental burdens.

Antony Currie: Ralph, you were relatively sanguine about government intervention earlier, compared with others. What's your view on this topic?

Ralph Daloisio: We spent 25 years getting the government out of our financial and economic system and created a lot of prosperity along the way. It seems that, within a year, they've come way back in, and more. My previously expressed view is certainly against the trend, and that's not a comfortable place to be, but where we can find consensus is that the trend is problematic. But I take comfort in the fact that at the core we have a representative form of government and a free and open society. At the end of the day, and mistakes will be made, and hopefully that gets self-corrected. We still have a Republican Party. They may be in hibernation, but there will probably come a time where there's hopefully a more balanced approach between the two extremes we've suddenly encountered.

Denise Crowley: Hopefully, calmer heads will prevail, and maybe Congress will see who the investors and PPIPs are: they are going to largely be pension funds, endowments, and so on, all kinds of regular Americans who are benefiting from those returns. Let's hope that when they actually see who the investors are, maybe they'll get a little bit of comfort, and maybe there is a silver lining to all of this that they may become more reasonable.

Michael Gambro: The audacity of hope.

Jason Kravitt: That's the point that investors have been making in the wars over rewriting mortgages, that it may be the teacher's house that gets taken, but it's the policeman's pension fund that gets screwed if you help the teacher inappropriately. That doesn't seem to have had much influence so far, so the question is will calmer heads prevail and will people look at it more rationally? Our elected representatives don't have a good record so far.

Ralph Daloisio: Did you take that one from me, by the way, the policeman's mortgage lives in the fireman's pension fund?

Jason Kravitt: I don't know. It's so good, it must not be mine.

Michael Gambro: To come to Ralph's defense, someone recently observed that people were very much concerned about the government involvement in Talf to begin with, but now people are more comfortable with it. Let's call it greed that seems to be driving people toward ignoring or pushing down some of those concerns. That may happen as well if people start investing successfully and selling successfully into these PPIP programs.

Ralph Daloisio: Thank you, Michael. I appreciate that.

Michael Gambro: You're welcome.

Richard D'Albert: But I would say there are significant investors, pension funds and others, who continue to be concerned about retroactive disclosure of their investors and different rules that might be put in place after they've invested that suddenly they become uncomfortable with. As a result, they're staying away from these types of programs.

Antony Currie: Let's flip it around: how's the U.S. taxpayer doing in all of this?

Ralph Daloisio: There's a difference between whether the taxpayer is getting the best deal he could get and whether or not his money is being putting at risk. So to Denise's point earlier, the right caution is being exercised to assure that the taxpayers' money is not being placed at unreasonable risk. But that doesn't mean they're getting the best deal they could be getting. Again, if someone from the government went around trying to collect money from households to put into this fund, the taxpayer may very well be better served by taking that same amount of money and giving it to some of the managers around this table and saying, "You invest it for me in these unlevered 20% worst case scenario bond profiles that you can get in the marketplace today," and therefore they end up with a better risk-adjusted return.

D'Albert and AmSec's Antony Currie

Jason Kravitt: First of all, I would rather give my money to Ralph, Denise and Richard than any government. Let me just go on the record.

Ralph Daloisio: We're going to take you up on that afterwards.

Jason Kravitt: But the government has more than one purpose in doing this: its predominant purpose, which dwarfs every other purpose, is to prevent the economy from utterly collapsing and going into a black hole instead

of just being a wounded beast at the moment. They didn't come up with the best deal conceivable for taxpayers, because they had the bigger overall goal of preventing the whole system from getting worse, and you have to be afraid if you don't leave a penny on the table that your own greed will kill the goose that lays the golden egg: 20% of a golden egg is better than 100% of nothing.

Antony Currie: Do you think that the government has made that point clearly enough?

Ralph Daloisio: It's really subjective, judgmental, and it's hard to point to anything tangible, but the concept was woven into the EESA legislation, where the Treasury Secretary was supposed to take into consideration the costs of inaction in relation to the costs of action in evaluating whether or not the taxpayer was getting a good outcome. So the concept's definitely there, but it's hard to demonstrate it because we cannot know for sure the alternative outcome.

Denise Crowley: Probably one of the best demonstrations of that is what the market has done. It was obviously pricing a massive disaster scenario into securities pricing, assuming that there was this tail event that could happen and could be very, very bad and required a very, very high return for assets that were not extraordinarily risky other than in these tail scenarios. That perceived risk has gone down considerably, because it seems like the government plans, in aggregate, are causing people to feel like that absolute disaster scenario is becoming less and less likely, so they're pricing in less of that tail.

Steve Kudenholdt: The question should not be: is the government getting the best deal or doing the best for Joe Taxpayer? It's whether they're doing the best job that they can to protect the public interest, the collective wealth of the country. They're doing a really good job with that. Sometimes it's more that these issues appear optically unfair to taxpayers — say when somebody is getting a bonus or whatever. But appearances should not be the driver.

Michael Gambro: I admire the fact that they've come up with these incredibly complex and creative programs. But I have to say the real question is how are we going to replace the securitization market, which provides so much financing for real estate in particular? Our clients talk about sticking their toe back in the water when it comes to CMBS-type programs. But there's a lot of debt out there on the commercial real estate side that has to be refinanced and there's just not enough balance sheet to make up the difference. So the effort to make this work for securitization is essential.

I just wonder when does it get to the point where you're able to get back to provide a meaningful amount of that bad word, leverage It's important to do so — credit is important. Without it, people will not be able to refinance, triggering another domino effect on the overall economy. That's my biggest concern.

I'm not particularly confident that the legacy loan program will be sufficient to get toxic assets off the balance sheets, exchanged for cash so that new lending can go on in that area. So I may be more negative than some of the other people at the table.

Steve Kudenholdt: It's about the new loans themselves, whether they're refis or modifications of existing properties. A lot of loans that are in CMBS pools have upcoming or have passed their balloon due dates. They just can't get refinanced at that same amount under current underwriting standards. There probably has to be some private capital equity infusion into these underlying projects, in many cases, in order to make for a viable refinancing. The economy is a huge driver of that because that's what really is going to drive the loss rates and the ability to refi these loans, more so than an implicit problem with the loans themselves when they were made — unlike some of the residential loans where the lending itself was fundamentally flawed.

What we don't have yet is anything under which there could be some sort of federal agency guarantee of triple-A debt issued by a new CMBS securitization. Perhaps the market will just have to find market clearing levels itself. But you still have to have that private equity contribution to make whole on the existing properties.

Daloisio

Bottorff and D'Albert

Denise Crowley: What is your feeling on Talf as it applies to new issue CMBS? That's potentially a way to bring equity investors in and revive that market. We haven't really seen it applied yet. We have seen it on the consumer side. I'm curious if you think that will make a big difference.

Michael Gambro: I understand there are eight or 10 proposals, notwithstanding the diversity requirement for new issue CMBS for single borrower deals to be Talf eligible. I think the idea is that single borrower, single property deals are too chunky for the Fed, but they will consider single borrower, multi-property deals, depending upon the sponsor. So people are definitely looking there. The best-in-breed real estate companies can get the capital. They can sell a secondary stock offering or unsecured debt. But for others, those that have more leverage on the property, the loans that are being offered are not going to provide that leverage no matter what the rate is.

Jason Kravitt: We've all come up with criticisms of what's happening, analyses that it may be better to do it this way or that way, et cetera. But I'm willing to bet that every person here really respects and admires what the Treasury and the Fed have been trying to do. You know, it may be that they do 12 things and five of them turn out to be bad and seven good, but that's really pretty good. There's no playbook for this, and they're maneuvering in not only uncharted waters, but shark-infested political waters. To come up with what they've done in the time frame and with the resources they've got, I think we all have to take our hats off to them. I don't think anybody here feels critical in an evil way. It's just that we're talking about ways that things might be improved.

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