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## FastFacts

### US Public-Private Investment Program (PPIP)

A view from our US equity desk

24 March 2009

*US stockmarkets climbed sharply on 23 March, recording their fourth-largest daily increase since the 1930s, after US Treasury Secretary Tim Geithner unveiled details of the plan to deal with toxic (or 'legacy' as they are now termed) assets residing on the balance sheets of banks and other financial institutions. These are still proving an impediment to lending and are exacerbating the current recession.*

*The S&P 500 index climbed by 7.1% on the day, with the S&P's financial sector rising by 16%. Markets were also aided by positive news regarding February's US home starts and existing home sales (the latter posting the largest monthly increase since 2003) and a 4% increase in oil prices, which boosted the construction and energy sectors respectively.*

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#### What the plan aims to do

The US Treasury says that the plan's aim is to stabilise the financial system and help it to recover by creating a market which will find a realistic price for the opaque mortgage-related securities currently residing on bank balance sheets. Banks will have the option of selling them, using the funds to strengthen their capital bases or alternatively lend to businesses and individuals at more competitive rates. It is hoped that uncertainty surrounding the scale of possible losses attributable to these assets will be reduced, giving both the market and economy a firmer base from which they can move forward.

The Treasury will enlist the help of selected private institutions, offering them low-interest loans and loan guarantees for a fee. US\$500bn will initially be provided to finance the legacy assets, and this could be expanded to US\$1 trillion over time.

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#### How the plan is to work in practice

The plan is in two parts, one dealing with loans and the other dealing with asset-backed securities.

In the legacy-loan side of the program, the Treasury and private investors will join forces to create investment funds which will purchase legacy loans from banks. The Treasury will provide one-half the equity capital for the fund and the private investor the other. The private investor will become the asset manager and the fund (a Public Private Investment Fund - PPIF) will come under the Federal Deposit Insurance Corporation's (the body regulating US bank deposit insurance - the FDIC) oversight. The FDIC will review the entity and determine how much additional funding it will be willing to guarantee the asset manager, loaning it up to six times the amount of its combined equity. Banks have the option of which legacy assets they wish to sell and the FDIC, which has experience of disposing of devalued loans from previously failed banks, will take them, pool them and auction them to a broad array of possible purchasers.

Under the legacy-securities program, securities linked to residential and commercial real estate, backed by mortgages and agency debt originally deemed triple-A rated, would have a market created for them by an expansion of the already existing Term Asset-backed Loan Facility. Non-recourse loans from the program to PPIFs will enable them to buy securitised assets, all of which should previously been triple-A rated. The fund manager, and there will be at least five of them, will need to demonstrate a proven track record of purchasing legacy assets before being selected as the Treasury's partner. For each dollar they raise the US

Treasury will match it. The fund manager will also be able to request non-recourse debt from the TALF up to the amount it put in itself, giving the PPIF purchasing power up to three times the amount it put in by the private investor.

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#### Why it is needed

The financial system of the United States and other troubled economies need to start functioning properly in order to stimulate economic growth and end the recession. If this does not happen, lending and economic activity will be curtailed, previously viable businesses will go bust and the recession is likely to lengthen or possibly deepen.

The previous administration, under President George W. Bush, planned to use funds from the Troubled Assets Relief Program (TARP) to purchase so-called 'toxic assets' from banks last October, but the funds were diverted to inject capital directly into banks to ensure that they did not go bust.

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#### What are the chances of it being successful?

There seems to be willingness from private investors to take part, and the positive market reaction is a hopeful sign. However, much of the possible success of the program depends on whether owners of distressed securities are willing to sell at the price determined in the auctions. Banks already marking-to-market 'legacy' troubled assets could see their asset values rise. Conversely, banks which have not priced their assets in this way risk being accused of overstating their value when a similar asset is priced in the auction system, forcing further writedowns upon them.

So far, investor interest has been strong, according to National Economic Council Director Larry Summers. Leading pension schemes and asset management companies have indicated that they wish to take part, as the five selected securities PPIFs, especially, are likely to be in a lucrative position. However, the problem of pricing loans remains, and the new auction system could have detrimental effects on those banks not yet marking their loans to market. It is also expected that banks will proffer their most impaired assets for auction first, and if they reject the offer price resulting from the auction negative sentiment could return to the market. Despite these reservations, this is a plan the market wants. It is not dissimilar to the workings of the Resolution and Trust Corporation (RTC), the body which successfully resolved the problems stemming from the Savings and Loans crisis of the early 1990s, so there are positives to be drawn. Unfortunately the current problems in the financial world are larger than the one the RTC had to correct and the possible US\$1 trillion committed to the program is still only a fraction of the overall legacy asset-related debt thought to be overhanging the financial sector.

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#### An Invesco Perpetual perspective

Andrew Shard, Head of US Equities at Invesco Perpetual, made the following comment in reaction to the events:

*"This plan is more coherent and wide-ranging than previous ones, offering investors both more detail as to how the authorities plan to address the issue of toxic assets on the balance sheets of financial institutions, as well as greater incentive to be partners in finding a solution to the crisis and protection on the downside for their participation. Unfortunately, the proposals cannot guarantee that sellers of such assets will be able to achieve the prices that they*



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*desire without the end result being significant further writedowns to asset values, which will potentially force them to raise significant amounts of new capital. If potential sellers truly believe that these assets are under-valued, and by holding them over the medium term that asset values will rise, why should they sell now and give away the upside?*

*For the Geithner proposals to work, we need to find a mutually acceptable clearing level for asset prices that does not bring further distress upon sellers, while giving potential investors an attractive potential return. This combination will be very hard to achieve. The market's significant rally in recent days is certainly implying that the odds of such an outcome have improved, but we would expect setbacks as the practical implications of the Geitner proposals unfold and further significant volatility in equity prices."*

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#### **Important information**

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