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TARP: Liquidity infusion, cleanup help get deals done

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With the global financial markets riding out one of the most turbulent times in history, deal professionals continue to ask the same key questions: What steps are being taken to unlock the credit markets; how long until we can get back to closing deals; and, as traditional business deals slow down, what business opportunities exist in connection with collectively working our way out of the financial crisis? While the stock market has made the front page headlines and captured the imagination of the pundits, the near total seizure in the credit markets presented imminent danger to our economy, threatening to cease day-to-day business from lending for commercial transactions on down to simple car loans.

On Oct. 3, President Bush signed the Emergency Economic Stabilization Act of 2008, creating the $700 billion Troubled Asset Relief Program ("TARP") and giving the Treasury Department 45 days to pass rules based on the statute. Much like the Marshall Plan to rebuild Europe after World War II, TARP will require the involvement of government, private investors and deal professionals alike, and it will be imperative to unlocking our economy from the current credit freeze. While the original purpose of TARP was to purchase troubled assets rather than buying equity in banks, the stubborn credit freeze necessitated Treasury Secretary Henry Paulson pumping $250 billion in equity into top banks shortly after TARP's passage. With every $1 of equity creating $10 in lending capability, this equity infusion immediately impacted the availability of loans, buying time for details to be ironed out on TARP's asset purchase program.

Just after the TARP's passage, the overnight LIBOR rate spiked to an all-time high of 6.88 percent. The U.S. government then worked with central banks around the globe to slash interest rates, enhance currency exchange programs and support bank-to-bank lending through guaranties and other measures, all in an effort to open up credit pipelines. Bank-to-bank lending rates dipped in response to these measures, an indication that government moves to stimulate the economy with money supply were having an effect. The overnight LIBOR rate dropped to 1.12 percent on Oct. 22, and could decrease further with talk of the Federal Reserve dropping its federal funds rate to 1 percent or lower. The sharp drop in the overnight LIBOR rate is a sign that some confidence is returning, at least in the short term.

The next step in the implementation of TARP entails the government buying illiquid, "toxic" assets from banks and securities firms, enabling them to raise capital, improve liquidity and resume lending. Extricating value from pools of "toxic" mortgage-backed securities will involve the government essentially establishing and overseeing a temporary mortgage servicing business, as well as creating a transparent market for previously opaque instruments like cash-settled equity swaps and over-the-counter credit-default swaps. In a traditional lender-borrower relationship, when trouble arises with the borrower's credit or with the property or assets serving as collateral, the lender and borrower negotiate a modification to the loan that enables the borrower to continue in possession of the property while complying with a revised payment and covenant package. The price tag for more lenient payment and covenant terms often is additional borrower equity. In other cases, the lender may absorb unfavorable terms to prevent a nonperforming loan from defaulting entirely if it believes the workout will yield more than an ugly foreclosure or bankruptcy process. Unfortunately, the current market for mortgage-backed securities impedes the ability of lenders and borrowers to work out poorly performing loans. While securitization of pools of mortgage-backed securities was intended to provide investors with diversification benefits, an unintended consequence has been convoluted capital structures that undermine attempts to conduct a modification or workout with a nonperforming borrower.

The government may exercise unique leverage to rehabilitate loans and to extricate valuable assets from these convoluted pools of mortgage-backed securities that have been written off by panicked markets as "toxic." In Congressional testimony on Oct. 23, Sheila Bair, chairwoman of the Federal Deposit Insurance Corp., noted that her agency and the Treasury Department are working to find ways to prevent foreclosures that can be averted. The plan would use the treasury secretary's new authority under TARP to provide guarantees to lenders. "Loan guarantees could be used as an incentive for servicers to modify loans. Specifically, the government could establish standards for loan modifications and provide guarantees for loans meeting those standards," noted Bair. However, many key open questions remain. Just how much authority will the government wield in recasting loan terms for loan modifications in ways that require lenders to accept some pain through "cram downs"? Will the government flex some muscle to enable loosening of typically tight securitized loan documentation to allow for more efficient removal of troubled assets from otherwise strong securitized pools in order to rehabilitate the pools?

Private equity investment will play a key role over the next several months and years in this brave new world. Private equity firms likely will find attractive opportunities amongst the rubble of loans to be sold off under the TARP. Although real estate loans do not offer the outsize returns typically required by private equity investors, strategic acquisitions of troubled loans secured by attractive properties or assets at deep discounts could offer private equity potential win-win outcomes. Should an acquired loan default, the buyer can obtain a desired asset in foreclosure or bankruptcy. Should the loan turn around and perform, with the buyer having acquired the loan at a deep discount (say, 50 percent to 60 percent of face value), the rehabilitated loan will have outperformed even private equity's high standards for returns on investment.

The Treasury's $250 billion equity investment in banks yields a preferred dividend return of 5 percent for the first five years and includes warrants to acquire additional stock at today's prices. This equity purchase makes Uncle Sam a senior partner in many of America's banks, but expect the government to exit these investments over time. As the crisis subsides, the conflicts of interest inherent in the Treasury acting as both regulator and investor in these chosen banks may prompt divestiture of this temporary partial "nationalization" of banks. Private equity firms likely will take out the Treasury on its equity investment in banks, with the warrants at today's low stock prices providing an attractive equity kicker.

The good news for broader transactional markets: The general consensus is that opportunistic private equity funds and strategic buyers are sitting on resources, waiting for the financial markets to achieve some equilibrium before capitalizing on value buys. As the government sells off troubled assets at discounted prices and sellers in the broader market come to grips with stubborn credit markets creating more difficult lending terms and likely dampening the heated prices of the past few years, private equity investment opportunities will become more and more attractive.▲