Structuring Distressed-Debt Relief with the Federal Government: Why It's So Hard and What to Do About It

Remarks by

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We're here today to look at TALF, PPIP and other federal programs aimed at moving distressed debt. It isn't easy and it's going very slowly, as all of you know all too well. So, what I'd like to do this afternoon is assess what went wrong, how well problems are now being resolved and – most important – how best to structure distress-debt programs going forward with the federal government.

This is not to suggest that TALF, PPIP and other efforts have been unsuccessful. TALF in particular is showing good signs, especially now that the first issue of newly-originated CMBS is in the works. PPIP is also beginning to pop, although it will clearly be a program at best in the $40 billion range instead of the $1 trillion initially planned by the Treasury. But, even with some green shoots, it's clear that more must be done, as evidenced by the scope of the residential-mortgage mess still unresolved, the magnitude of the commercial real estate one now upon us and the parlous condition of other critical asset classes.

So, how to get these programs working better and new ones to market more quickly? As I'll detail in a moment, the biggest obstacle to the programs to date is the bumpy intersection between the private and public sector. Put simply, making money and serving the public good are not necessarily incompatible, but they're a most uncomfortable fit. Conflicts of interest to which Wall Street has long accustomed itself can be flat-out scandalous when looked upon by Congress. Worrying about retail customers – mortgage borrowers facing foreclosure, for example – is at best an after-thought in deal design, but it's a first-order concern for many policy-makers. Are using minority or women-owned contractors top of the list other than in municipal transactions? Of course not, but it's become a major issue dealing with Treasury. And, then, of course, there's compensation – pay packets at which many of you might sneer look ludicrously lucrative to some in Washington. Any transactions that appear to provide them take toxic assets and make them downright radioactive.

Another significant issue is the uncomfortable cultural intersection between New York and Washington. I know it's a bit off to go all anthropological on you, but I've seen it over and over again in distress-debt and private-equity transactions. Accustomed to shock and awe, Wall Street comes to Washington expecting to thunk a wad of bills on a government official's table, watch jaws drop and then do a deal. This happens a lot in distressed deals with private parties, especially when sellers have their backs against the wall. It's a lot less effective in Washington, where policy-makers aren't judged by margin, ROE or similar criteria. They like doing deals that make money just fine, but they keep or lose their jobs based on how well they achieve – or at least are seen as achieving – policy objectives.

TALF and PPIP took so long because first, they were far too complex in their initial design and, then, they included an array of problematic features that alarmed Members of

Congress. These forced the Fed and Treasury back to the drawing board, delaying the programs and threatening their credibility. Did this have to happen? I don't think so. Had better thought been given in advance to ensuring that programs with public money meet legitimate public-policy objectives, toxic assets might have been turned into government-backed distressed-debt obligations far more quickly. How to do this is the topic I'll address today.

Design Out of Reach

When TALF, PPIP and other programs first were broached, most of the initial structuring was done by folks on the Street with a lot of help from the lawyers. Much in the initial design was based on known precepts – for example, relying on the credit rating agencies. Oops. The deals were also highly engineered, building on all the structured transactions those who built these had previously constructed. Of course, CDO structures were often complex because of regulatory-capital arbitrage, issuer incentives and other factors that, at best, are an uneasy fit with federal dollars at risk.

Once the initial deal designers did what they thought was their magic, they took the ideas to friends at the Fed and Treasury, many of whom had long Street experience themselves. These officials looked at transactions more from an execution than a policy or political perspective. They thus tweaked the deals to reflect their own concerns – most notably reducing risk to the federal government in the initial deal structures – and then sent the transactions on to their own lawyers. To put it succinctly, the transactions didn't get any easier.

They were, though, then sold to senior officials at the Fed and Treasury. It's important to remember why this happened. First, last fall, the Fed and Treasury were essentially desperate and any program that purported to move toxic assets looked pretty darn good compared with the alternatives. Also, even through the spring as TALF was finalized and PPIP advanced, many of the most senior policy-makers blessing them had a lot of affinity for Street-style transactions. As a result, the transactions looked not just viable, but also flat-out cool – always a selling point for the susceptible. Of course, the "cool" aspects of the transactions served a critical policy purpose: they didn't put taxpayer dollars at immediate risk so no new law was – at least arguably – required.

So far, I've focused on the TALF and PPIP, but the history I've outlined also applies to the FDIC's attempt to construct a program to move distressed debt from open banks. As you all know, the legacy-loan program or LLP is on ice, with the FDIC instead trying a similar structure only for assets it holds in receivership from failed banks. Many of the complexities and conflicts that dogged TALF and PPIP were also initially embedded in the LLP, leading to its very slow start. Take, for example, the demand from banks that they be allowed to buy assets they sold into the LLP. This did a heck of a lot for the bid-ask spread, factoring in 6:1leverage based on FDIC-guaranteed paper. However, it fired up critics who argued – as I did at the time – that this is an inherent conflict of interest the

FDIC lacked experience and expertise to manage. Similar conflicts were embedded in the initial PPIP structure until Congress got word of them and flatly barred this.

Now, What?

As we turn to new ways to use TALF, PPIP and the LLP, it's critical to review program revisions – let alone any new distressed-debt plans – with a clear eye on the government's policy objectives and what Congress will think about how well these are met. Highly-engineered programs that seek to handle internal conflict through complex cross-checks or by just relying on the rating-agencies haven't worked well to date and will do even worse going forward. The FRB and Treasury launched their programs without clear advanced thought as to what Congress would think of them and were caught very short by unanticipated critiques and, in some cases, new law. They won't do that again, meaning that any variations to current programs and any new ventures will be constructed up-front with forethought about policy and political impact.