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Public-Private Investment Program and TALF Expansion

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Highlights

The Treasury's Public-Private Investment Program (PPIP) introduces up to $1 trillion of leverage into a financial system that remains under intense deleveraging pressure. This should be a significant positive for valuations of the targeted assets.

The PPIP establishes a framework that builds on the success of TALF, which has driven ABS spreads 300-400 basis points tighter since its announcement in late November. There are complexities to the PPIP framework, but the big positive in the PPIP announcement is the expansion of TALF for secondary securities. Expanded TALF will allow financing of AAA CMBS and RMBS that were originally rated AAA.

The program addresses and responds to key political realities. The government-private equity co-investment feature of the program effectively addresses the issue of whether private investors would disproportionately benefit at the expense of the taxpayer.

A major question related to the potential success of the program is whether asset owners will sell. The key constraint is whether bids will be high enough relative to marks for owners and whether the sale would induce a significant loss.

On the loan side, the seeds of growth for PPIP will come from acquired bank residential mortgage portfolios, which, by virtue of recent acquisitions, are owned at levels potentially reasonably close to market clearing levels. In addition, regulators may force the sale of loans to PPIP as a means of cleaning up insolvent institutions. With up to 6:1 leverage available, we estimate that as much as $200-$300 billion of loans could be sold at attractive prices.

On the securities side, we think CMBS stand to benefit more than RMBS as a result of the more stable ratings profile of AAA CMBS, which likely will make leverage potential greater and less risky. CMBS has rallied strongly on the announcement while RMBS has had a more measured response. **We turn overweight super-senior AAA CMBS and think spreads can rally as much as 400-500 basis points over the coming months. Furthermore, we increase our non-agency allocation to neutral from underweight.**

Many details of the program still need to be ironed out. But that was the case with TALF for ABS. Policy proved to be responsive and many details were ultimately addressed to do what was necessary in order to make the program a success.

Similarly, political risk at a broad level remains. But this plan, a centerpiece of the Obama administration's response to the crisis, fills the policy vacuum that has existed over the past two months and that allowed the recent escalation of rhetoric and political risk. Filling the vacuum may well diffuse the political risks. The equity market's strong embrace of the plan certainly helps that process.

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Public-Private Investment Program Overview and Mechanics

Through targeted investments in multiple Public-Private Investment Funds (PPIFs), which were first outlined as part of the Financial Stability Plan by Treasury Secretary Geithner on February 10, PPIP intends to ultimately "draw new private capital into the market by providing government equity co-investment and attractive public financing."[1]

We think that this program could first stop, then reverse the negative feedback loop of declining asset prices and delevering, which leads to further price declines that has plagued the markets over the past year. Furthermore, we expect the program will be successful in both an economic and political context as it allows:

1. **owners** of legacy assets to sell securities and loans above the prevailing market prices, which currently embed an unsustainably high liquidity premium. As asset prices increase, holders of like assets will potentially be able to write up the value of their holdings and free up capital that may be used to repay TARP money, promote new or additional private-sector loans, or encourage the purchase of additional risky assets.

2. **purchasers, or private investors,** to utilize the balance sheet of both the Treasury and Fed to leverage their investments over a longer-term horizon with no mark-to-market exposure, and

3. **taxpayers** to share in the upside, which avoids the potential conflict in which the government gets all of the downside yet shares in none of the upside. Furthermore, because private sector investors will be competing for these assets in auction with the government as a passive investor, it limits the likelihood that the "winning" entity would materially overpay.

The Public Private Investment Program, which is slated to use $75 to $100 billion of TARP funds, will have purchasing power estimated to total between $500 billion and $1 trillion and is set to contain two parts: the Legacy Loans Program and the Legacy Securities Program. While the Legacy Loans Program will work to remove existing real estate loans from bank balance sheets, the Legacy Securities Program will facilitate the purchase of secondary market securities collateralized by portfolios of legacy residential and commercial real estate loans.

Both programs involve the formation of Public-Private Investment Funds (PPIFs). In its announcement, the Treasury was quick to emphasize that both taxpayers and private investors will benefit from the formation of PPIFs and the purchase of these legacy assets. It is important to note that any equity contribution put forth by the Treasury is considered a use of funds allocated through TARP and EESA, and thus "the purchase price of the Treasury equity investment in the PPIFs will count against the $700 billion cap."[2]

Legacy Loans Program

In the Legacy Loans program, detailed in Chart 1, PPIFs will be formed through a joint and equal equity contribution by private investors and the Treasury. In addition to the contribution of equity by the Treasury and private investors, the FDIC will facilitate financing through a debt guarantee of up to 6:1 leverage, depending on the particular asset up for purchase. The level of leverage will vary for each asset pool based upon analyses by the FDIC and a third party. The FDIC will provide a debt guarantee for the PPIF, collateralized by the purchased assets and in exchange for a debt guarantee fee. These PPIFs will then be allowed to purchase, through an FDIC-governed auction, select legacy loans from participating banks. Loans are deemed eligible for purchase by PPIFs if they meet a set of yet-to-be determined criteria imposed by the FDIC and the Treasury.

Upon auction of the loans, the purchase price is determined based upon the bid from the highest bidder for the 50% equity contribution by the private investor. After that, Treasury provides a matching equity contribution, and the FDIC will guarantee the remainder. Using the example provided in the PPIP whitepaper, a bank would first select a pool of mortgages it wishes to sell. The FDIC would determine how much it would be

[1] Public-Private Investment Program Whitepaper, U.S. Department of the Treasury

[2] Legacy Securities Public-Private Investment Funds (PPIFs) Frequently Asked Questions, U.S. Department of the Treasury

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willing to leverage the pool, up to a maximum of 6-to-1. The pool would next be auctioned by the FDIC to a group of private investors. Given a winning bid of $84, a 6-to-1 leverage ratio implies $12 of equity, which is shared equally between the private investor and the Treasury. Under the plan, after asset purchase, it is the private investor's responsibility to manage the asset and the Treasury's responsibility to manage its equity stake.

Finally, the announcement noted that the executive compensation restrictions will not apply to "passive Private Investors" involved in the program. It is not clear, nor is it stated, what restrictions (if any) will apply to those entities that sell assets into the program.

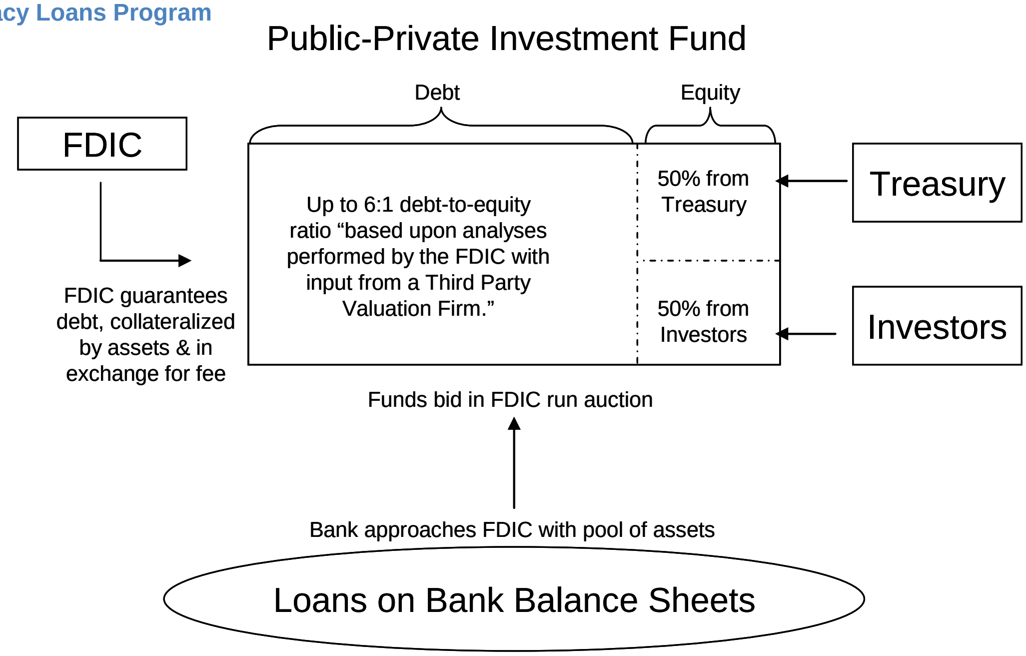
Legacy Securities Program

The Legacy Securities program itself involves two parts: the formation of PPIFs to purchase legacy securities and the expansion of the Term Asset-Backed Securities Loan Facility (TALF) (Chart 2).

First, the Legacy Securities program involves the formation of PPIFs similar to the Legacy Loans program. Private investors that meet a select set of criteria will be chosen as "Fund Managers" to oversee these PPIFs and raise private equity. Once equity has been raised, the Treasury will contribute a proportional equity stake. Whereas debt issued by PPIFs in the Legacy Loans program was guaranteed by the FDIC, debt financing for the Legacy Securities program comes from the Treasury. The Treasury has the ability to provide debt financing of "up to 50% of total equity capital,"[3] and an additional loan "in amounts of up to 100% of the total equity capital of a Legacy Securities PPIF." "This senior debt will have the same duration as the underlying fund and will be repaid on a pro-rata basis as principal repayments or disposition proceeds are realized by the PPIF. These senior loans will be structurally subordinated to any financing extended by the Federal Reserve to these PPIFs via the TALF."[4]

The PPIF will then be responsible for purchasing legacy securities with these funds, namely non-agency RMBS and CMBS with *original* ratings of AAA. The securitized assets must have been issued prior to 2009, be

Chart 1: Legacy Loans Program



Source: J.P. Morgan

[3] Ibid
[4] Public-Private Investment Program Whitepaper, U.S. Department of the Treasury

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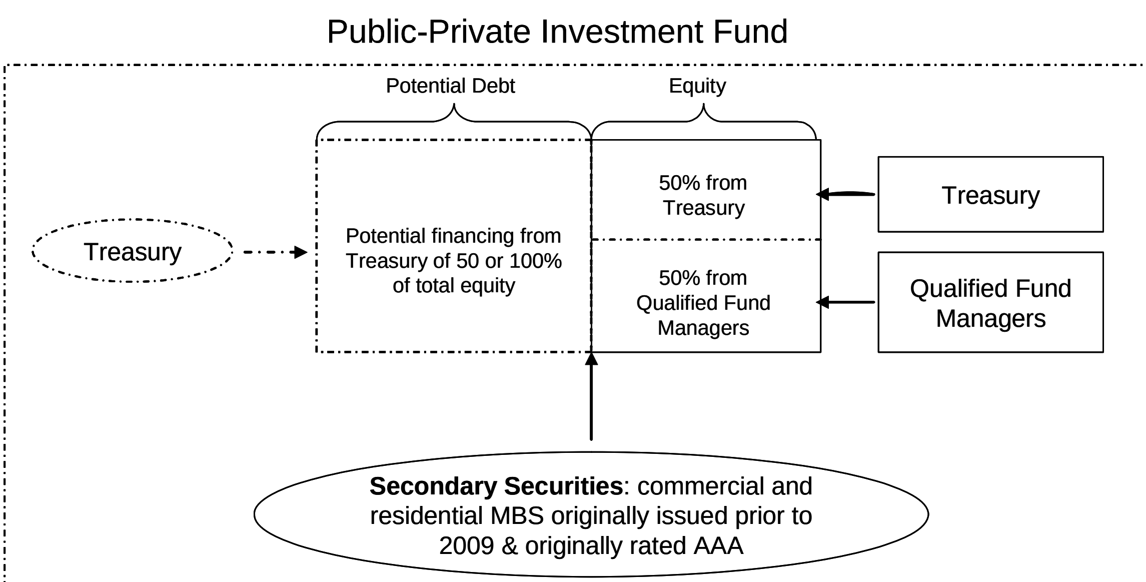
secured directly by "actual mortgage loans, leases or other assets, and not by other securities,"[5] and be backed by assets primarily located in the United States.

Additionally, Treasury states in its Public-Private Investment Program whitepaper that it intends to expand TALF to allow for the financing of legacy assets. Specifically, the whitepaper states "Through this expansion of the TALF, non-recourse loans will be made available to investors to fund purchases of legacy securitization assets." The whitepaper also states "Furthermore, fund managers (FMs) will have the ability, to the extent their fund structures meet certain guidelines, to subscribe to Treasury for senior debt for the PPIFs in the amount of up to 50% of a fund's total equity capital, and Treasury will consider requests for senior debt for the PPIFs in the amount of up to 100% of a fund's total equity capital subject to further restrictions on asset level leverage, redemption rights, disposition priorities, and other factors Treasury deems relevant. This senior debt will have the same duration as the underlying fund and will be repaid on a pro-rata basis as principal repayments or disposition proceeds are realized by the PPIF. These senior loans will be structurally subordinated to any financing extended by the Federal Reserve to these PPIFs via the TALF."

Whereas the original TALF program dealt with newly originated auto, credit card, and student loan ABS, the expanded version of TALF will include "certain non-agency residential mortgage-backed securities that were originally rated AAA, and outstanding commercial mortgage-backed securities and ABS that are rated AAA."[6] **The inclusion of select RMBS and CMBS, particularly secondary market securities, in this new translation of TALF was highly anticipated, given its potential to significantly improve lending and liquidity.** As with TALF 1.0, this expansion will provide non-recourse loans, though haircuts and terms have not yet been set. There had been concern in the CMBS and RMBS markets around ultimate loan terms and the need to better match the long duration nature of the asset. There was some encouragement in the announcement in the form of the recognition of the potential mismatch. The announcements stipulated that

Chart 2: Legacy Securities Program



Source: J.P. Morgan

[5] Legacy Securities Public-Private Investment Funds (PPIFs) Frequently Asked Questions, U.S. Department of the Treasury

[6] Public-Private Investment Program Whitepaper, U.S. Department of the Treasury

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the Federal Reserve was considering the duration of the underlying asset when determining the duration of financing.

Additionally, it is important to note the distinction between securities allowed under the expansion of TALF and the initial instances of Legacy Security PPIFs. Whereas TALF 2.0 is expected to include CMBS or RMBS *currently* rated AAA, PPIFs are mentioned as being allowed to purchase CMBS/RMBS that were rated AAA *at origination*, regardless of their current rating. This implies to us that if a PPIF purchases an 'AJ,' for example, which has subsequently been downgraded, that it would be unable to obtain additional financing from TALF for Legacy Assets. **Regardless, taken together, this strongly implies to us that investors that buy legacy assets will ultimately have the option to use TALF to finance the purchase of these assets.**

Asset specific impact – commercial real estate loans and bonds

With the creation of PPIP and the expected future eligibility of AAA CMBS in TALF for Legacy Assets, we shift to an overweight recommendation on super senior and 'AM' triple-A CMBS. Given a five-year TALF loan term, fund managers that set up PPIFs to buy super-senior triple-A CMBS could realize levered returns above 15% even in situations in which they walk away at the end of the loan term. **Furthermore, as secondary bond spreads tighten it will allow whole loan spreads to compress, which should alleviate some of the tension on the refinance market. If we consider the spread movement seen in the consumer ABS market as a proxy, AAA CMBS spreads could rally to levels as tight as S+600 over the next few months from their current level of approximately S+1,000.**

Although some of the language in the PPIP whitepaper is open to interpretation, it appears at this point that the best bang for the buck would be to use the PPIP Legacy Securities program in conjunction with TALF for Legacy Assets loan. Although haircuts and loan terms have yet to be finalized, in Tables 1 and 2 we show matrices that detail potential levered yields across a range of haircut and bond spreads. In Table 1 we show expected annual levered yields assuming the investor pays back the TALF loan at the end of the fifth year, while in Table 2 we show expected annual yields if the investor puts the loan back at the end of the fifth year.

Table 1: Levered yield matrix assuming investor repays TALF loan at the end of a 5-year loan term

LEVERED YIELD WITH TALF FINANCING

Bond	JPMCC 07-CB20 A4	TALF Term	5.0
WAL	8.31	TALF Spread	100
		Put Bond at Term	No

BOND PRICING		**TALF HAIRCUT**						
Spread	$PX	10.0%	12.5%	15.0%	17.5%	20.0%	22.5%	25.0%
400	93.96	13.3%	12.7%	12.2%	11.8%	11.4%	11.0%	10.7%
450	91.05	14.8%	14.1%	13.5%	13.0%	12.5%	12.1%	11.8%
500	88.25	16.4%	15.5%	14.8%	14.2%	13.7%	13.3%	12.8%
550	85.56	18.0%	17.0%	16.2%	15.5%	14.9%	14.4%	13.9%
600	82.97	19.7%	18.5%	17.6%	16.8%	16.1%	15.5%	15.0%
650	80.48	21.4%	20.1%	19.0%	18.1%	17.3%	16.6%	16.1%
700	78.09	23.3%	21.7%	20.4%	19.4%	18.5%	17.8%	17.1%
750	75.78	25.2%	23.3%	21.9%	20.8%	19.8%	19.0%	18.2%
800	73.56	27.3%	25.1%	23.4%	22.1%	21.1%	20.1%	19.3%
850	71.43	29.4%	26.9%	25.0%	23.5%	22.3%	21.3%	20.5%
900	69.37	31.8%	28.8%	26.6%	25.0%	23.6%	22.5%	21.6%
950	67.39	34.3%	30.7%	28.3%	26.4%	25.0%	23.8%	22.7%
1000	65.48	37.1%	32.8%	30.0%	28.0%	26.3%	25.0%	23.9%
1050	63.64	40.1%	35.0%	31.8%	29.5%	27.7%	26.3%	25.0%
1100	61.87	43.5%	37.3%	33.7%	31.1%	29.1%	27.5%	26.2%
1150	60.17	47.4%	39.8%	35.6%	32.7%	30.6%	28.9%	27.4%
1200	58.52	51.8%	42.5%	37.6%	34.4%	32.1%	30.2%	28.6%

Source: J.P. Morgan

Table 2: Levered yield matrix assuming investor "walks away" at the end of a 5-year loan term

LEVERED YIELD WITH TALF FINANCING

Bond	JPMCC 07-CB20 A4	TALF Term	5.0
WAL	8.31	TALF Spread	100
		Put Bond at Term	Yes

BOND PRICING		**TALF HAIRCUT**						
Spread	$PX	10.0%	12.5%	15.0%	17.5%	20.0%	22.5%	25.0%
400	93.96	23.3%	13.1%	5.9%	0.4%	-4.0%	-7.5%	-10.5%
450	91.05	26.5%	15.9%	8.3%	2.6%	-1.9%	-5.6%	-8.7%
500	88.25	29.8%	18.6%	10.8%	4.8%	0.1%	-3.7%	-6.9%
550	85.56	33.1%	21.4%	13.2%	7.0%	2.2%	-1.8%	-5.1%
600	82.97	36.4%	24.2%	15.7%	9.3%	4.2%	0.1%	-3.3%
650	80.48	39.8%	27.0%	18.1%	11.5%	6.2%	2.0%	-1.6%
700	78.09	43.2%	29.9%	20.6%	13.7%	8.3%	3.9%	0.2%
750	75.78	46.7%	32.8%	23.1%	16.0%	10.3%	5.8%	2.0%
800	73.56	50.2%	35.7%	25.7%	18.2%	12.4%	7.7%	3.8%
850	71.43	53.8%	38.6%	28.2%	20.5%	14.5%	9.6%	5.6%
900	69.37	57.4%	41.6%	30.8%	22.8%	16.5%	11.5%	7.4%
950	67.39	61.2%	44.6%	33.4%	25.1%	18.6%	13.5%	9.2%
1000	65.48	65.0%	47.7%	36.0%	27.4%	20.7%	15.4%	11.0%
1050	63.64	68.8%	50.8%	38.6%	29.7%	22.9%	17.3%	12.8%
1100	61.87	72.8%	54.0%	41.3%	32.1%	25.0%	19.3%	14.6%
1150	60.17	76.9%	57.2%	44.0%	34.5%	27.2%	21.3%	16.4%
1200	58.52	81.0%	60.5%	46.8%	36.9%	29.3%	23.3%	18.3%

Source: J.P. Morgan

Regardless of whether or not the investor repays the TALF loan at the end of the loan term, if we assume a five-year loan term, 15% haircut and financing spread of S+100, investors looking for annual levered returns above 15% could purchase super-senior triple-A CMBS at spreads as tight as S+600 before the hurdle can't be satisfied. As the Tables indicate, this amount of spread compression would result in asset prices increasing by approximately 20 points from their current levels, which would allow real money investors to substantially write up the assets they currently own.

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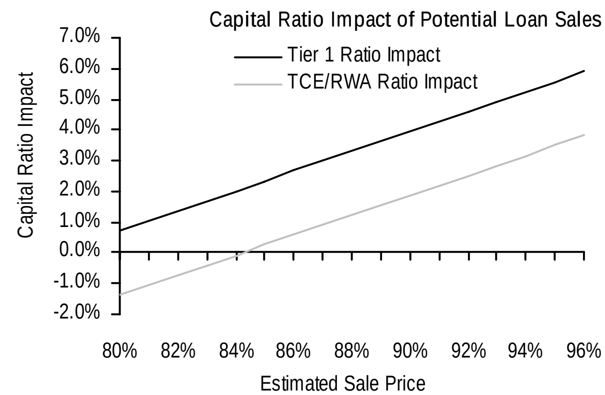
As opposed to TALF loans made against consumer ABS, which have shorter average lives, the longer average life of most CMBS would provide a substantial funding mis-match and would likely deter private participation in the program. Therefore, we show the data in Tables 1 and 2 assuming a five-year TALF loan because we believe that is the minimum loan term investors would need to participate in this program, given that it matches the term of underlying five-year 'A2' bonds. One obvious question might be what occurs if investors that purchase CMBS with 10-year original average lives if the TALF financing term only lasts for five years and is subsequently not renewed. Interestingly, at haircuts in the mid-teens, the purchasing power the leverage affords coupled with the relatively high coupon and discount dollar price at which these bonds currently trade, investors that do not repay the TALF loan at the end of the five-year term actually enjoy higher annual returns than those investors that come out of pocket to repay the loan!

While we expect the benefit to commercial real estate loans held on insurance company and commercial bank portfolios will be muted in relation to that enjoyed by CMBS, we do think it will be moderately positive for banks that remain saddled with "stuck" financial sponsor loans related to the leveraged buyout deals that became common in 2006-2007. We hold off on any analysis in this report, however, given that the ultimate returns of the Legacy Loans program is heavily dependent on where these loans are currently marked and how much higher the bid would need to be to induce one to sell.

In addition, we believe this program, coupled with TALF 2.0, will spur new lending. As the price for triple-A CMBS securities increases, the whole-loan spread required for a new origination will narrow. This will allow banks or insurance companies to offer more favorable loan terms to new borrowers or to borrowers that need to refinance, and subsequently securitize those loans through TALF 2.0. While this may do little to minimize the losses experienced by deals collateralized by the most aggressively underwritten loans, we expect the ultimate cumulative level of losses will remain below the super-senior triple-A, making its ultimate impact on the PPIP negligible.

Chart 3: Impact of loan sales at different price points relative to book value on capital ratios



Source: J.P. Morgan

Asset specific impact - residential mortgage loans

Currently U.S. banks hold roughly $2.5 trillion in unsecuritized mortgage loans. Although the rationale for the Legacy Loans Program is to offer an avenue for banks to sell troubled loans that have been stuck on their balance sheets, banks in general will be reluctant to sell loans at market value if they have to realize significant losses, which would be an immediate hit to capital . However, loans which were subject to purchase accounting adjustments at the time of acquisitions could be good candidates for sale into the program. Looking at recent large bank M&A transactions, we estimate that there are over $180bn, net of purchase accounting adjustments, of mortgage loans that are potentially marked closer to market values due to recent bank acquisitions. On average, these loans were marked down by 30% at the time of acquisition.

Furthermore, if banks can get a reasonable price for selling the loans, they can potentially earn more over time (from fees, servicing, securitization) through originating new loans to replace the ones that they sold. We are not suggesting that banks will be selling all of these assets as they are currently helping banks' net interest margins, and given the markdowns already taken through purchase accounting, they could be profitable holding these loans maturity. The amount of loans sold will obviously ultimately depend on what the investment fund is willing to pay for them and where the banks own them. While current market conditions may not warrant

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a sale, the availability of leverage may gradually allow prices to move higher, similar to what TALF did for ABS, and reach a point where loan sales could make sense. Banks may also be inclined to sell by considering the impact of loans sales on their capital ratios. For example, Chart 3 shows the impact of sales at different price points relative to book value on capital ratios for a major bank: even if sales are made at prices slightly below average book value of $85, the shrinkage of the balance sheet enables modest improvement of the bank's capital ratios.

An alternative source of loans would be through the forced sale of loans by institutions that do not pass the coming stress tests. The PPIP provides a powerful, market clearing mechanism for assets held by these institutions. This could prove to be the most effective component of PPIP on the loan side.

Asset specific impact - residential mortgage securities

We expect the Legacy Securities program, as it relates to RMBS, to have a smaller impact relative to CMBS. The big issue with the securities portion is that the financial institutions would be required to realize a significant loss relative to where the securities are currently trading in the market. Given the recent potential changes to OTTI accounting where banks can treat credit losses separately from liquidity related losses, we find it unlikely that banks would sell into the current market. That could change as the leverage introduced into the system gradually pushes prices higher.

However, PPIP does set up a facility to handle potential liquidations that could come from the upcoming stress test scenarios, whereby banks would potentially need to liquidate some assets. Moreover, negative rating actions have continued to concern the non-agency market with investors uncertain about the amount of liquidations we could see from the bank, insurance and asset management community. The Legacy Securities program creates a mechanism to deal with these issues and provides much needed cash to support the sector, a net positive.

We expect marginal prime paper that has been pressured by ratings downgrades to be the first to improve. The massive volume of downgrades that has occurred over the past few months pushed real money investors out of the market. These bonds are not expected to have significant writedowns and with a little leverage can improve significantly in price.

The PPIP will establish a floor for pricing by putting at least five asset managers in competition with one another to purchase legacy assets with some potential leverage. However, the expansion of TALF to include legacy assets that previously had a rating of AAA could be the biggest news. It has been somewhat overshadowed by the complexities around the PPIP.

While we continue to find the non-agency sector cheap, there is still significant policy risk in the near-term. Regardless, the potential impact of leverage on non-agency securities (match funded with a 50% haircut) can be quite substantial. Let's take a marginal prime fixed-rate bond that trades in the high 40s and assume a 50% haircut and a 3% funding level. Unlevered investors command a 20% ROE. A 2x levered investor could achieve the same return and purchase the asset in the high 60s, a 20 point price improvement.

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JPM Global Equity Research Coverage	42%	40%	18%
IB clients*	44%	47%	37%
JPMSI Equity Research Coverage	38%	47%	15%
IB clients*	62%	57%	47%

*Percentage of investment banking clients in each rating category.
For purposes only of NASD/NYSE ratings distribution rules, our Overweight rating falls into a buy rating category; our Neutral rating falls into a hold rating category; and our Underweight rating falls into a sell rating category.

Options related research: Entering into options transactions entails certain risks with which you should be familiar. If the information contained herein regards options related research, such information is available only to persons who have received the proper option risk disclosure documents. In connection with the information provided above, you acknowledge that you have received the Options Clearing Corporation's Characteristics and Risks of Standardized Options. If you have not received the OCC documents and prior to reviewing the information provided above, contact your JPMorgan representative or refer to the OCC website http://www.optionsclearing.com/publications/risks/riskstoc.pdf.