Client Advisory

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Economic Crisis Reshapes Role of Government in the Market

In response to the growing global economic crisis, the U.S. Government has intervened in the financial markets to an extent not seen since the Great Depression. The price of intervention will not only be measured in the billions, but also in terms of major reforms to the financial regulatory system.

Today's turmoil stems from market instability caused by the precipitous decline in U.S. home prices. As homeowners, particularly those with subprime mortgages, defaulted in record numbers, home foreclosures escalated, and home values fell, financial institutions saw the value of their mortgage-related assets plummet. Numerous highly leveraged institutions have declared bankruptcy or have been forced to merge with better capitalized competitors. Not trusting asset valuations or credit-worthiness, financial institutions have pulled back from lending to one another. Credit for businesses and consumers, if it is available, remains extraordinarily constrained. World stock markets gyrate daily, often to new lows. Many blame the regulatory system for failing to protect consumers and the financial system. Since the first major federal intervention eight months ago, calls for major regulatory reform have grown louder.

To avert a worldwide spin into financial gridlock, the Federal Reserve and the U.S. Department of the Treasury have undertaken extraordinary measures ranging from the rescue of Bear Stearns and AIG and taking conservatorship of Fannie Mae and Freddie Mac, to flushing the economy with liquidity through rate cuts, paying interest on sterile reserves at the Fed, and coordinating with other central banks to reduce interest rates. Additionally, the Fed has launched three major initiatives to provide liquidity directly to businesses and mutual funds: (1) an Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, (2) a Commercial Paper Funding Facility and (3) a Money Market Investor Funding Facility. The FDIC has greatly widened deposit insurance coverage. Perhaps the most extraordinary intervention will be Treasury's implementation of the Emergency Economic Security Act ("ESSA") that is intended to infuse the banking system with capital and shore up the market for distressed assets. Collectively, these governmental actions should help to restore confidence in the financial system and restore credit flows.

Emergency Economic Stabilization Act

After Congress shook world stock markets when it failed in its first attempt to approve financial rescue legislation on September 29, 2008, the public finally realized the financial crisis affected not just Wall Street, but also Main Street. Lawmakers returned days later and approved EESA, authorizing the creation of a $700 billion Troubled Asset Relief Program ("TARP") and a Troubled Asset Insurance Finance Fund ("TAIFF") to guarantee troubled mortgage assets.[1] The law gives Treasury broad latitude in setting up and managing the TARP under a new Office of Financial Stability. EESA also raised FDIC deposit insurance from $100,000 to $250,000 per insured account to discourage bank runs.[2]

[1] Public Law 110-343, which can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h1424enr.txt.pdf.

[2] In a separate action, the FDIC announced October 14 it would temporarily guarantee the senior debt of all FDIC-insured institutions and certain holding companies, as well as deposits in non-interest bearing deposit transaction accounts which tend to be commercial accounts.

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The principal means by which Treasury will implement the TARP will be 1) to purchase "troubled assets" from financial institutions, and 2) to make equity investments in financial institutions through a Capital Purchase Program ("CPP") pursuant to its authority to purchase financial instruments the purchase of which are deemed necessary to promote market stability.[3]

The TARP's purchase of "troubled assets[4]" is intended to provide price stability for residential and commercial mortgages and mortgage-related financial products, which in today's market cannot be sold or are difficult to sell. Currently, financial institutions must carry these illiquid assets at extremely low values on their balance sheets. According to Secretary Paulson's testimony, the TARP will pay more than "fire sale prices" and will take into account hold-to-maturity valuations. Not only will institutions selling their "troubled assets" receive much needed liquidity, but their balance sheets should improve as market prices stabilize for all mortgage-related securities. Once the market stabilizes, the Treasury could begin to sell off the assets, possibly returning a profit to taxpayers.

Only "financial institutions" may sell troubled assets to the TARP; however, the term is broadly defined to include banks, thrifts, credit unions, securities brokers or dealers, or insurance companies having "significant operations in the United States." Foreign central banks or institutions owned by a foreign government are specifically excluded. The requirement of significant U.S. operations does not preclude small or mid-sized financial institutions from eligibility. EESA specifically ensures that participation in the TARP be made "without discrimination based on size, geography, form of organization, or the size, type, and number of assets eligible for purchase under this Act."

Almost daily, Treasury reveals new details about the TARP's implementation. On October 14, 2008, Treasury announced the Capital Purchase Program by which the TARP will purchase $250 billion of preferred stock in financial institutions, with half going to nine of the nation's largest banks. The universe of financial institutions eligible to participate in the CPP is smaller than those eligible to sell mortgage-related assets to the TARP. Only banks, thrifts, bank and S&L holding companies, and financial holding companies may apply to receive capital funding from the CPP. Insurance companies are reportedly among those who have already applied to participate in the CPP. In exchange for the capital infusion, financial institutions will pay 5% annual dividends for the first five years with a 9% rate thereafter. Initially, only publicly held institutions may participate and they must provide warrants for non-voting common stock. Treasury intends to permit non-publicly held banking institutions to participate and, with a nod to community bankers, Treasury officials have emphasized that "the same terms will be available to small and medium-sized banks and thrifts across the nation."

While Treasury's implementation plans are well underway, the CPP is the first program launch. Financial institutions qualifying for the CPP must apply by November 14, 2008. Treasury has indicated it will complete CPP capital infusions by year-end. The TARP's purchase of "troubled assets" is expected to begin between mid-November and mid-December. Authority for TARP acquisitions ends December 31,

[3] Treasury also has indicated that it is working on another program that potentially would provide direct assistance to certain failing institutions on a case-by-case basis.

[4] Under Sec. 3 (9), the term "troubled assets" means:

(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and

(B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.

2009, but may be extended until October 2, 2010. The TAIFF remains in the development stage. Public comments on how to structure the guaranty program are due October 28, 2008.

A New Era of Government Regulation

Government intervention in the financial markets carries not only an extraordinary monetary cost to taxpayers, but also imposes significant restrictions on the financial institutions. Entities benefiting from the TARP's funding will be subject to a host of requirements mandated by EESA, depending upon the assistance received, including provision of warrants, restrictions on executive compensation, and possibly recoupment of losses suffered by the Treasury. Stronger governmental regulation of financial institutions will not be limited to EESA.

During a number of hearings preceding enactment of the financial rescue package, Fed Chairman Bernanke and others repeatedly warned that the U.S. financial regulatory system must be overhauled. Earlier this year, the Treasury Department released its "Blueprint for Modernized Financial Regulatory Structure" and Secretary Paulson detailed recommendations that would create a prudential supervisor of all depositories, a consumer protection regulator, and a market stability regulator. EESA itself requires the Treasury Department to issue a "Regulatory Modernization Report" no later than April 2009.

Congress has already launched into consideration of the issues it must address in restructuring the financial regulatory system. Several hearings are scheduled in advance of the November 4 election to examine the causes of the financial crisis and to consider what reforms are necessary to provide a stronger, more robust regulatory system that provides greater market stability while protecting consumers. For example, on October 21, 2008, the House Financial Services Committee held a hearing on "Regulatory Restructuring and the Reform of the Financial System" where academics and financial industry witnesses provided regulatory reform recommendations.

While the presidential candidates rarely address regulatory reform, both Sen. Obama and Sen. McCain have endorsed the need for consolidation of the financial regulatory agencies based upon function and strengthening oversight. Sen. Obama has elaborated more on his view and laid out in a speech six principles he believes are necessary to regulatory reform. Among those cited is a need to streamline regulation and to impose stricter capital requirements on activities that present liquidity risk. Sen. Obama would also broaden the range of financial providers subject to regulation, including ratings agencies and hedge funds.

With a new President and a new Congress beginning in January, next year's legislative and oversight agenda should prove to be extremely active as policymakers seek to help stabilize the American economy and the global financial market. A wholesale reform of financial services regulation will be central to that discussion.

A summary of "The Emergency Economic Stabilization Act" follows on page 4.

Summary of the Emergency Economic Stabilization Act

Enacted on October 3, 2008, the Emergency Economic Stabilization Act ("EESA") authorized the U.S. Department of the Treasury to establish a Troubled Asset Relief Program ("TARP") to provide liquidity to financial institutions and to restore market stability. Using broad discretion granted by the law, Treasury is moving quickly to implement the $700 billion program under the newly created Office of Financial Stability. On October 14, 2008, Treasury announced that the TARP will purchase up to $250 billion of senior preferred stock, with half of that amount going into nine of the nation's largest financial institutions. Treasury has also begun the process of selecting asset managers, a custodian, and other parties necessary for implementation and management of the program. In addition to the TARP, EESA requires Treasury to establish a Troubled Asset Insurance Finance Fund ("TAIFF") to guarantee "troubled assets."

Highlights of key EESA provisions follow.

Troubled Asset Purchase Program

- **Overview**: Congress authorized up to $700 billion for TARP to purchase "troubled assets" from "financial institutions" on terms and conditions it decides in consultation with the Federal Reserve Board, Federal Reserve Bank of New York, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and Office of the Comptroller of the Currency, and to consult with the FDIC in managing such purchased assets. Authority for acquiring TARP assets expires December 31, 2009, but it may be extended until October 2, 2010 with notice to Congress.
- **Treasury Implementation Authority**: Treasury has wide discretion in establishing the policies and procedures for implementing EESA, including how it will identify, price, and purchase troubled assets, and the process by which asset managers and others will be engaged. Treasury must issue "regulations or guidelines necessary to address and manage or prohibit conflicts of interest." When procuring services, Treasury will follow Federal Acquisition Regulation ("FAR") requirements, but it has the flexibility to use previously established FAR provision applicable under conditions of unusual and compelling urgency.
- **TARP Funds**: EESA authorizes up to $700 billion to fund TARP, but the funds will be released in tranches: $250 billion is immediately available; another $100 billion is authorized upon a Presidential certification of need, and the final installment of $350 billion will be made available if requested by the President and Congress does not pass a joint resolution of disapproval within 15 days.
- **Who May Participate?**: Almost any regulated financial institution with significant operations in the United States, including, but not limited to, banks, credit unions, security brokers or dealers, and insurance companies, without discrimination as to size. Foreign central banks and institutions owned by foreign governments are excluded. While EESA is not clear, legislative history appears to exclude private equity and hedge funds from participation as well.
- **What Assets are Eligible?**: There are two classes of eligible assets: (1) residential or commercial mortgages and related instruments that were originated or issued on or before March 14, 2008,[5] "the purchase of which the Secretary determines promotes financial security," and (2) "any other financial instrument" that the Secretary, after consultation with the Chairman of the Federal Reserve, determines "the purchase of which is necessary to promote financial market stability." It is under this second asset category that Treasury exercised its authority to establish the Capital Purchase Program and acquire preferred stock directly from financial institutions.

[5] March 14, 2008 is the date of the Bear Stearns bailout.

- **How Will Assets be Purchased?**: EESA directs Treasury to make purchases at the lowest cost consistent with market stability and that it should use market mechanisms. Two methods are contemplated by the law: (1) an auction process, including reverse auctions, and (2) by direct purchase. Treasury announced on October 15 the Bank of New York Mellon will serve as custodian of the TARP's assets and will manage the auctions.

- **Protecting Taxpayers from Losses**:

  - **Warrants/Equity**: To permit taxpayers to participate in gains enjoyed by a financial institution selling assets directly to the TARP and to cover costs and losses, Treasury will receive warrants for non-voting stock when the financial institution is publicly traded on a U.S. stock exchange, or if it is not publicly traded, the Treasury may take equity or senior debt.[6]

  - **Recoupment**: After five years, if Treasury determines TARP has lost money for taxpayers, then the President must submit a proposal to Congress as to how to recoup such losses "from the financial industry." Congress would then have to enact legislation to recover the losses.

- **Restrictions on Financial Institutions Participating in TARP**:

  - **Executive Compensation Restrictions**: If Treasury purchases assets directly, the participating institution must adhere to standards limiting incentives for inappropriate risk-taking, allowing a "clawback" of executive compensation in certain circumstances and prohibiting "golden parachutes." If Treasury purchases assets at auction, institutions selling over $300 million of assets to the Treasury cannot deduct executive compensation paid over $500,000 and any such institution is prohibited from giving "golden parachutes" to employees hired after the purchase.

  - **No Unjust Enrichment**: Financial institutions cannot sell troubled assets to Treasury for more than they paid.

Other EESA Provisions

- **Guaranty Program**: Treasury must establish a Troubled Assets Insurance Finance Fund ("TAIFF") to guarantee "troubled assets" with risk based premiums paid by participating institutions sufficient to cover anticipated claims. TARP purchasing authority is reduced by the amount of the guarantee less guarantee premiums paid into the TAIFF. Treasury is soliciting input on how to structure the TAIFF pursuant to a Request for Comment that was published October 10, 2008.[7]

- **Oversight**: EESA establishes numerous panels to oversee Treasury's implementation and management of the Act, including a Financial Stability Oversight Board and a Congressional Oversight Panel. The GAO, the Comptroller General and a Special Inspector General have oversight responsibilities as well.

- **Reports**: EESA requires Treasury, oversight bodies and other banking agencies to regularly report to Congress upon purchases, pricing, expenses and the impact of TARP. By April 30, 2009, Treasury must submit a "Regulatory Modernization Report." GAO shall undertake studies on the impact of leveraging and deleveraging that contributed to the financial crisis. Numerous other reports are required as well.

- **Foreclosure Mitigation**: With respect to acquired mortgages and mortgage-backed securities ("MBS"), Treasury shall implement a plan mitigating foreclosures and encouraging servicers to modify loans through HUD's Hope for Homeowners program. Federal entities holding mortgages and MBS also shall

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6 ESSA directs Treasury to establish a "De Minimis" exception to these requirements when cumulative purchases of troubled assets from one financial institution are not more than $100,000,000 for the duration of the program. Thus, smaller institutions may escape the requirement to provide warrants or debt or equity to the Treasury.

7 The Request for Comment can be found at: http://treas.gov/press/releases/reports/federalregisternotice1.pdf.

seek to minimize foreclosures and encourage loan modifications, considering net present value to taxpayer. Treasury may use loan guarantees and credit enhancements to avoid foreclosures.

- **Loan Modification**: Treasury shall implement a plan to assist homeowners with troubled mortgages to refinance into FHA loans. Treasury may also use loan guarantees and credit enhancement to facilitate loan modifications.
- **Judicial Review**: Actions by the Secretary are subject to the "arbitrary and capricious standard" of review under the Administrative Procedure Act. Relief is generally limited to actual damages, but injunctions are permitted for non-asset management related activities. No person that "divests its assets" may bring an action against the Secretary, and actions will be considered on an expedited basis.
- **Mark-to-Market Accounting**: The Securities and Exchange Commission is authorized to suspend mark-to-market accounting.
- **Tax Provisions**:
  - **GSE Preferred Stock**: Banks, thrifts, small business investment companies, and business development corporations that suffered losses from Fannie Mae and Freddie Mac preferred stock may deduct the loss against ordinary income rather than treating it as a capital gain loss.
  - **Mortgage Modification**: EESA extends to January 1, 2013 the exemption from federal taxes of any income that a homeowner would otherwise be taxed upon from the amount of debt forgiveness arising from a mortgage loan modification.
- **Deposit Insurance Coverage Increased**: EESA raises FDIC and NCUA insurance from $100,000 to $250,000 per insured deposit account through December 31, 2009.
- **Public Debt**: The cap on the federal debt was raised to $11.315 trillion to accommodate the cost of TARP.
- **Unrelated Titles**: EESA also included other bills not related to the economic crisis that extended several expiring tax provisions and energy-related programs.

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Lisa is part of Kelley Drye's multidisciplinary initiative to assist our clients navigate the financial crisis and ensuing economic downturn through advocacy before legislators and regulators, providing transactional advice on distressed assets to investors and lending institutions, defending clients in government and Congressional investigations, and serving as litigation counsel to companies across the world and industrial spectrum.