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The Obama Administration's Prescription for the Economy

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In February, Treasury Secretary Timothy Geithner rolled out the Obama Administration's "Financial Stability Plan." The plan, in conjunction with the nearly $800 billion economic stimulus legislation Congress enacted, is designed to give a one-two punch to restore liquidity to capital markets, stabilize the financial system, address the moribund housing market, mitigate against foreclosures, and stimulate the economy. "We have to both jumpstart job creation and private investment, and we must get credit flowing again to businesses and families," Geithner said in his February 10 speech.

Initially, the Secretary provided only an outline of the stability plan, giving few details much to the markets' and legislators' dismay. Since then, however, details have been emerging, and the plan's implementation is well underway. It is designed to complement liquidity programs offered by the Federal Reserve Board (the Fed) and the Federal Deposit Insurance Corporation (FDIC). The plan builds upon the $700 billion Troubled Asset Relief Program (TARP) established under the Emergency Economic Stabilization Act (EESA) that was enacted in September 2008 to rescue the financial system from a feared collapse. The multi-faceted plan will ultimately move over $2 trillion into the economy through several programs and entails new transparency and accountability standards.

The Administration has created a comprehensive website on all the programs it has implemented to address the economic crisis, including the Financial Stability Plan, which can be found at http://www.financialstability.gov.

A summary of the following Financial Stability Plan programs follows, along with an explanation of the state of their implementation:

I. **The Financial Stability Trust** – measures the capital strength of the nation's largest financial institutions, and provides means to assure their on-going stability;

II. **The Public Private Investment Program** – helps to get financial markets working again by moving targeted troubled assets from financial institutions into investment funds co-owned by private investors and the U.S. Treasury;

III. **Expansion of the Term Asset-Backed Securities Loan Facility (TALF)** – assists in restoring liquidity to the asset-backed securities (ABS) market by providing attractive financing to investors purchasing the securities;

IV. **Housing Support and Foreclosure Prevention** – implements programs to stem the tide of mortgage foreclosures and to make mortgage loans affordable;

V. **Small Business and Community Lending Initiative** – opens up credit markets for small business lending through the Small Business Administration; and

VI. **Transparency and Accountability Requirements** – promote lending, increase integrity, and protect taxpayers.

Whether these programs will provide the medicine needed to restore the health of the economy remains to be seen. Since coming into office 100 days ago, the Obama Administration has embarked upon an unprecedented economic triage to remedy the extraordinary ails affecting the economy.

I. Financial Stability Trust: To Stabilize The Financial System And Restore Markets

A cornerstone of the Financial Stability Plan is to assure that the nation's largest banks can withstand an even more severe economic downturn than is anticipated. To that end, federal banking regulators are establishing uniform standards to clean up and strengthen banks' balance sheets, and to conduct a comprehensive "stress test" to measure an individual institution's ability to weather a severely worsening economy. The test is required of the 19 financial institutions with more than $100 billion in assets and for any financial institution seeking to obtain capital from a new Capital Assistance Program to be established under the TARP. The results of the exams, which are to be released May 4, will help regulators assess the need for additional capital.

Should regulators determine additional capital is needed to cushion an institution's balance sheet, the institution will be given six months to raise capital from the private markets. Additional capital will also be available under the Capital Assistance Program (CAP). This capital, in the form of a convertible preferred security, is intended to serve as a "capital buffer" until the institution can attract new capital from the private sector. While the Treasury has not allocated specific funds for capital infusions from the CAP, Secretary Geithner has indicated the funds would be made available as needed. As of April 21, Treasury reported TARP had $109.6 billion in resources that remain uncommitted.

The CAP program differs from the Capital Purchase Program (CPP) previously set up under the TARP, although both programs provide TARP funds to bolster financial institutions' capital positions in exchange for preferred stock and warrants. Unlike the CPP, funds from the CAP will not be provided to acquire failing institutions. Participants in the CPP may exchange their preferred stock for the CAP's convertible preferred security, but will become subject to the more stringent executive compensation standards imposed by the 2009 economic stimulus law. Conversion of the CAP preferred security into common stock bolsters an important measure of financial strength – Total Common Equity.

Some view the CAP as a means to avoid nationalization of major financial institutions should the economy become far worse than expected. The stress tests may also prove to be a useful tool in assessing which assets a financial institution may want to sell through the Public - Private Investment Program to strengthen its capital position. The test results will also help to determine whether a financial institution has the financial strength to return TARP funds to the Treasury. Several institutions, including JPMorgan Chase and Goldman Sachs, have announced they would like to return the capital received from the CPP. On April 21, Treasury Secretary Geithner told the TARP Congressional Oversight Board that he would welcome return of the funds from financially strong institutions, provided it did not reduce credit availability in the economy as a whole.

II. Public-Private Investment Fund: To Get Financial Markets Working Again ($500 Billion - $1 Trillion)

To address the so-called "legacy assets" burdening financial institutions' balance sheets, the Financial Stability Plan proposes to establish a "Public-Private Investment Program" whereby

financial institutions could sell their troubled real estate-related assets to investment funds owned jointly by private investors and the Treasury. Nicknamed “P-PIP,” the program is being implemented jointly by the Treasury Department and the FDIC.

Treasury Secretary Geithner has said a range of options are under consideration, and has stressed they will seek input from the Congress and the public. Initially capitalized with $500 billion through equity contributions and federal financing, P-PIP could be scaled up to $1 trillion. The idea is to not only move the toxic assets off banks’ balance sheets, but also to establish a private market pricing mechanism to determine the price for current troubled and previously illiquid assets.

P-PIP will be comprised of two programs: the Legacy Loans Program and the Legacies Securities Program.

Each program will permit investors to receive a matching federal equity contribution to purchase distressed assets from financial institutions at auctions overseen by the FDIC. Selling institutions, however, may reject the winning bid. To entice investors and to leverage up the investment, attractive federal financing is available for the asset purchases. Profits and losses will be shared on a pro rata basis between the Treasury (i.e. taxpayers) and investors based upon their respective equity contributions. Examples of the investment process for both programs are attached in Appendix A.

The Legacy Loans Program

The Legacy Loans Program is targeted to residential and commercial mortgage real estate whole loans and pools of loans held by FDIC-insured financial institutions. Investors will be able to bid on packages of loans offered by individual financial institutions. Each package of loans purchased will be held in a separate Public-Private Investment Fund (PPIF). Thus, investors will have a direct interest in the asset purchased. The Treasury will hire investment management firms to manage the assets, although investors will determine the disposition of the assets.

PPIFs will finance the purchase of eligible asset pools from the participating banks by issuing debt guaranteed by the FDIC and secured by the assets. Proposed financing terms and leverage ratios for each PPIF will be established by the FDIC and disclosed to potential investors before the bidding process begins. In no case may the amount of loan guarantee exceed six times the total equity contribution.

The Legacy Securities Program

The Legacy Securities Program is targeted to real estate-related securities held by financial institutions as defined by the Emergency Economic Stabilization Act (includes, for example, insured depositories, thrift and bank holding companies, and insurance companies.) Eligible assets will initially be commercial mortgage-backed securities and residential mortgage-backed securities issued prior to 2009 that were originally rated AAA without credit enhancements.

The Treasury will engage approximately five investment managers who will each establish a PPIF to purchase the troubled securities offered at auction. Investors participate by investing in a PPIF. Thus, the investment is akin to an investment in a mutual fund.

Applications to become an investment manager under the Legacy Securities Program were due by April 24. Although the principal investment managers are expected to demonstrate capacity to raise at least $500 million of private capital and experience in managing at least $10 billion in assets, Treasury indicated some flexibility in the criteria for investment managers to qualify in guidance

released April 6. The guidance also clarified that smaller asset managers, particularly those owned by veterans, minorities, and women, may partner with the qualifying fund managers before or after the application deadline. Treasury expects to inform applicants regarding preliminary qualifications by May 15.

To finance their asset purchases, a PPIF under the Legacy Securities Program may obtain secured non-recourse loans from the Treasury (Treasury Debt Financing) in an aggregate amount of up to 50 percent of a fund's total equity provided private investors have no voluntary withdrawal rights. Treasury will consider requests for such financing up to 100 percent of equity capital subject to certain restrictions. The PPIF's assets will secure the Treasury Debt Financing.

Legacy securities funds may also obtain financing from the TALF administered by the Federal Reserve Bank of New York, any other Treasury program or debt financing raised by private sources. Regardless of the debt source, Treasury capital and private capital must be leveraged proportionately.

P-PIP Faces Many Issues

Initially, under both programs, only real estate-related assets will be eligible. However, the Treasury and the FDIC are considering the expansion of the programs to other classes of assets. The FDIC sought public comments on what assets should be eligible along with many other details on the program. Because P-PIP is subject to the restrictions imposed by EESA, the Treasury must grapple with issues such as how to determine the level of warrants the Treasury should acquire from the investment funds established under P-PIP.

A particularly thorny question is whether EESA's executive compensation restrictions will apply to the investment managers or the participating banks. The Treasury's March 23 announcement stated that the executive compensation restrictions would not apply to passive investors, but was silent as to those actively investing and managing assets. In his April 21 appearance before the Congressional TARP Oversight Board, Secretary Geithner provided some clarity, saying that these restrictions would apply to sellers and not to investors. He blamed the slow start of investors participating in the TALF due to the fear executive compensation restrictions would be imposed on them. In a veiled warning to Congress, which has been enraged over bonus payments to AIG executives, the Secretary warned that few investors will participate in the P-PIP unless they are confident no rule changes will be imposed retroactively.

No one within the Administration is venturing to guess when the P-PIP will be fully operational. FDIC Chairman Sheila Bair indicated in remarks April 23 that the FDIC would offer initial loan packages to investors as part of the Legacy Loans Programs in June. This will be a pilot sale to test the program's "mechanics" and "allow for public observation and input." The more complex Legacy Securities Program is likely to take longer to get off the ground. Moreover, concerns raised by the TARP's Special Inspector General and others about the potential for collusion between P-PIP participants may slow implementation as Treasury and the FDIC fashion rules to prevent conflicts-of-interest.

III. Expansion Of TALF: To Revitalize Lending And Increase Credit Availability For Consumers And Businesses (Up To $1 Trillion)

While the PPIF and the capital assistance programs are designed to shore up financial institutions and restore their lending capacity, the Financial Stability Plan also addresses the severe credit constraints of the ABS market by providing additional support to the TALF which is administered by the Federal Reserve Bank of New York. The goal of TALF is to provide liquidity to the ABS market by

providing attractive financing to investors purchasing the securities.

Initially back-stopped with $20 billion of TARP funds, the TALF was designed to lend funds to investors purchasing securities backed by consumer debt for automobiles, credit cards, and student loans; auto dealer floor plans and small business loans. The Administration has increased its pledge to cover losses that might arise from the TALF to $100 billion of TARP monies. Such support will enable the TALF to finance the purchase of up to $1 trillion in ABS.

Very significantly, the Administration's plan has substantially broadened the ABS classes eligible for TALF financing to include private label residential mortgage-backed securities, commercial mortgage-backed securities, ABS-backed by vehicle fleet leases, ABS-backed by equipment loans and leases, and mortgage servicing advances.

The issuers of the ABS, however, have some hurdles to overcome. First, the security must have an investment grade rating (e.g., AAA) from two or more nationally recognized credit rating agencies without additional credit enhancements, such as a third-party guarantee. Thus, to acquire the high credit rating, the issuer of debt on riskier assets will have to over-collateralize the security. For a rough example, to create a $100,000,000 ABS, the issuer may have to put in $120,000,000 worth of debt on eligible assets to help cover the potential default of up to $20,000,0000. Moreover, the investors will have to take a "haircut" on the loan they obtain from the TALF. The Fed has published a schedule that designates the size of the haircut, which ranges from 5 percent to 16 percent depending on the asset class and the life of the ABS. E.g., to obtain financing of $90,000,000, the investor would have to put up $100,000,000 in ABS as collateral if the required haircut is 10 percent.

TALF Off to Slow Start

Investors' initial interest in TALF financing has been tepid. The first TALF-eligible deals involving securitized automobile loans and credit-card ABS began in March, but investors only applied for $4.71 billion in loans. The second round was even more anemic, and produced only $1.71 billion in loan applications. Curbs on hiring foreign workers, extensive paperwork, and fears of congressional intervention have purportedly hindered the program. The three-year financing term has particularly discouraged investors interested in buying long-term commercial mortgage-backed securities. The Fed may extend the term for CMBS to five years to facilitate lending in the commercial mortgage market.

The Federal Reserve Board has already begun to tweak the TALF program to make it more attractive to investors. On April 22, the Fed changed the interest rates on certain loans secured by ABS with weighted average lives to maturity (WALM) of less than two years. The new rates will be based on one- and two-year London interbank offered (Libor) swap rates, resulting in a better match to the duration of the underlying ABS collateral.

Subscriptions for the May funding will be accepted on May 5, and the loans will settle on May 12. The TALF, however, has a very long way to go before it meets the goal of providing $1 trillion of lending to spur the ABS credit market.

IV. Housing Support And Foreclosure Prevention: To Stem Mortgage Foreclosures And To Make Mortgage Loans Affordable

Among the various components of the Administration's Financial Stability plan, the first to produce benefits visible to consumers is its housing program to avoid foreclosures and to avoid the risk of another housing crisis.

Welcomed by the banking industries, consumer groups, and especially homeowners, the Obama Administration’s housing stabilization plan will purportedly help one in nine homeowners refinance or modify their mortgage to more affordable terms. The goal is to stem the tide of foreclosures and to stabilize housing prices. In his initial announcement on February 10, Treasury Secretary Geithner said the President had committed $50 billion from the TARP to support the program.

On March 5, details of the program, called the “Making Home Affordable” program, were released by the Treasury and bank regulators, and Fannie Mae and Freddie Mac issued guidelines. Mortgage lenders report that their phones have been ringing off the hook as homeowners seek to take advantage of the program along with lower mortgage rates brought on by the Fed’s massive purchases of Treasury securities and mortgage-backed securities issued by the GSEs. But, as usual, the devil is in the details and not everyone will qualify.

Basically, there are two components to the plan: a refinancing program for borrowers who are current on their mortgage loan, and a separate loan modification program targeted to homeowners who can demonstrate they have suffered a hardship making their mortgage unaffordable, and are at “imminent risk” of default. Both programs will make mortgage payments more affordable for homeowners. Whether the programs will succeed in preventing an estimated 7-9 million foreclosures remains to be seen.

Especially for the modification program, there are numerous hurdles that the borrower and the mortgage servicer must mount to qualify. However, the program’s financial incentives should encourage servicers and investors to modify loans, and will reward servicers and homeowners when mortgage payments are kept current following the modification. There are also incentives to encourage the release of junior liens. Heretofore, second lien holders have impeded modifications to the first mortgage by refusing to subordinate their interest for fear they would never be compensated.

The refinance program is fairly straightforward, but it is limited to homeowners whose mortgage was owned or securitized by Fannie Mae or Freddie Mac, and who are current on their mortgage. To their credit, Treasury, Fannie Mae, and Freddie Mac have held lengthy conference calls with the mortgage industry to explain details of the program so that refinances and modifications can commence. Moreover, homeowners can call Fannie Mae and Freddie Mac or check their websites to determine whether their mortgage is owned or securitized by either.

The “Home Affordable Refinance Program”

To qualify for a refinance, a borrower must:

- Have a conforming loan owned or securitized by Fannie Mae or Freddie Mac;
- Be current on their mortgage payment;
- Own and occupy the home;
- Have sufficient income to support the new mortgage debt; and
- Not owe more than 105 percent of their home’s current value. E.g., If the property is worth $200,000, the borrower can owe no more than $210,000.

The precipitous decline in housing prices has prevented many homeowners from taking advantage of today’s lower interest rates because they lacked enough equity in the home to meet the standard 80

percent loan-to-value ratio required for conforming mortgages. This program will permit the refinance of homes with mortgages of up to 105 percent of the home’s current value.

A big plus for homeowners who have a second mortgage is that the 105 percent loan-to-value limitation only applies to the first mortgage. As long as the second lien holder agrees to subordinate to the new first mortgage, the original first mortgage may be refinanced. The 105 percent limitation, however, will prevent many homeowners – especially in those states where home prices have fallen the most such as CA, FL, and NV – from qualifying as their mortgage may simply be too far “under water” to qualify. For them, mortgage modification might be an option.

Another plus for the program is that a new credit report is not required, except for certain Freddie Mac loans when private mortgage insurance premiums must be increased.

The “Home Affordable Modification Program”

To be eligible for a modification, a homeowner must:

- Own and occupy the home (in a one to four unit property);
- Have an unpaid mortgage balance equal to or less than $729,750;
- Have obtained the loan before Jan. 1, 2009;
- Have a mortgage payment (including taxes, insurance, and homeowners’ association dues) that is more than 31 percent of the borrowers’ gross monthly income; and
- Have experienced a significant change in income or expenses, to the point that the current mortgage payment is not longer affordable.

Unlike traditional mortgage modifications, a homeowner need not be delinquent on their loan to receive a modification. The key criteria is whether the homeowner has had a change in circumstances that causes financial hardship or is facing a recent or imminent increase in the payment that is likely to create a financial hardship. A borrower must be screened and prove with documentation that they have suffered a hardship, such as a loss of employment, an unaffordable spike in the loan’s interest rate, or other circumstance that creates the strong likelihood they cannot make their mortgage payments in the immediate future. Income must also be verified.

Under the guidelines, servicers must utilize a “waterfall” approach to reduce borrowers’ mortgage payments to no more than 31 percent of their income. First, the servicer must reduce the payment to no more than 38 percent of income by reducing the interest to as low as 2 percent, and then, if necessary, to extend the loan’s term to 40 years. The government will then match additional reductions in the payment until the payment is lowered to 31 percent of income. After five years, the interest rate can increase 1 percent annually.

Investors, servicers and borrowers are all eligible to receive incentives for modifying loans and keeping them current. Incentives are higher for modifying loans that are current than for loans that are delinquent. Incentives are only payable after the a 90-day trial period where the borrower has made payments on a timely basis. Borrowers who continue to keep their payments current will receive up to $1,000 annually toward principal reduction for up to five years.

Servicers will receive $1,000 for successfully modifying a delinquent loan and $1,500 for a current loan, and additional incentives for up to 3 years provided the loans remains current. Investors will

receive a subsidy for a portion of the cost to reduce the interest rate to an affordable level and will receive a one-time incentive payment of $1,500 for agreeing to modify a loan that is not delinquent. The payments for keeping mortgages current are designed to tackle the problem of recurring delinquency that has plagued many mortgages modified under the HOPE NOW Alliance initiative and other programs.

Investor and servicer participation in the Home Affordable Modification program is voluntary except it will be mandatory for financial institutions that accept future funding from the Treasury's Financial Stability program. Participating servicers will sign a contract with the Treasury and then will be required to modify all loans that meet the eligibility requirements and pass a specified net present value test, demonstrating that modification is better than foreclosure. Modification will not be required if there is fraud or the modification is prohibited by the pooling and servicing agreement that governs the servicing of the loan.

The Administration is working with Congress to enact legislation that will allow FHA, VA and USDA to offer modifications consistent with the Making Home Affordable Program.

V. Small Business And Community Lending Initiative: To Spur Lending For These Troubled Markets

The seizing up of the ABS market has brought a virtual halt to the credit market for small businesses that rely on loans guaranteed by the Small Business Administration (SBA). Investors have stopped purchasing securities backed by SBA guaranteed loans. Institutions that securitize these loans have been unable to find buyers for the securities they have already packaged. In turn, the securitizers have been unwilling to acquire new loans to package for fear they will not be able to sell them. Consequently, banks that depend on the secondary market for liquidity have become reluctant to extend credit to small businesses. As a result, many small business owners find they no longer have access to credit.

The Administration's Financial Stability Plan has a multi-prong approach to revitalizing the small business lending market:

- The Treasury has committed to buying securities backed by SBA loans, thereby becoming a major purchaser in the secondary market.
- To make SBA loans more attractive to small businesses, the SBA is temporarily eliminating the loan guarantee fees for Section 7(a) loans, which are intended for entrepreneurs looking to start, expand or acquire a small business. Loan guarantee fees for Section 7(a) loans currently range from 2 percent - 3.75 percent.
- The SBA is also temporarily eliminating Certified Development Company Section 504 loan fees, which offer small businesses long-term, fixed-rate financing for major fixed assets, such as land, buildings, machinery and equipment. Loan fees temporarily eliminated include the 1.5 percent application fee charged to small businesses and the ½ percent fee charged to the originating mortgage lender.
- Investors interested in purchasing securities backed by SBA loans may obtain attractive financing from the TALF. The "haircut" required for such TALF financing is 5 percent for ABS with an average life of 5 years or less, and 6 percent for ABS with average maturities greater than 5 years and less than 7 years.

- The IRS issued guidance on an expedited basis for provisions in the economic stimulus law that were targeted to assisting small businesses, including a provision to permit businesses with gross receipts of up to $15 million to “carry back” their losses for up to five years instead of two years.

VI. Transparency And Accountability Requirements: To Promote Lending, Increase Integrity And Protect Taxpayers

Institutions that participate in these federal programs will become subject to a host of new transparency and accountability requirements, including, for example:

- Demonstrating in detail how assistance will expand lending;
- Committing to mortgage foreclosure mitigation;
- Restricting dividends to $.01, restricting share repurchases, and restricting cash acquisitions of healthy firms; and
- Limiting executive compensation.

How these new transparency and accountability requirements will affect participation in the program is unclear. Absent directives from their federal regulators, many financial institutions may be reluctant to participate in the programs under the Financial Stability Plan.

Mortgage servicers have been the first to step up to the plate to sign onto the Mortgage Modification Plan, and financial institutions that received capital infusions under the Capital Assistance Program are required to participate in the mortgage program. In contrast, the poor participation in TALF speaks to investors’ unwillingness to expose themselves to unclear or yet-to-be-determined restrictions. To date, for example, few major investment managers have announced plans to apply to become investment advisors under the P-PIP’s Legacy Securities Program, although Blackrock and PIMCO said early on they would apply.

Until the Obama Administration can convince financial players that it is worth the risk to take the medicine the Financial Stability Plan prescribes, the recovery of the economy’s health remains in jeopardy.

Appendix A: The Public-Private Investment Program Investment Process

Sample Investment Under the Legacy Loans Program*

Step 1: If a bank has a pool of residential mortgages with $100 face value that it is seeking to divest, the bank would approach the FDIC.

Step 2: The FDIC would determine, according to the above process, that they would be willing to leverage the pool at a 6-to-1 debt-to-equity ratio.

Step 3: The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bid from the private sector – in this example, $84 – would be the winner and would form a Public-Private Investment Fund to purchase the pool of mortgages.

Step 4: Of this $84 purchase price, the FDIC would provide guarantees for $72 of financing, leaving $12 of equity.

Step 5: The Treasury would then provide 50 percent of the equity funding required on a side-by-side basis with the investor. In this example, Treasury would invest approximately $6, with the private investor contributing $6.

Step 6: The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis – using asset managers approved and subject to oversight by the FDIC.

Sample Investment Under the Legacy Securities Program*

Step 1: Treasury will launch the application process for managers interested in the Legacy Securities Program.

Step 2: A fund manager submits a proposal and is pre-qualified to raise private capital to participate in joint investment programs with Treasury.

Step 3: The Government agrees to provide a one-for-one match for every dollar of private capital that the fund manager raises and to provide fund-level leverage for the proposed Public-Private Investment Fund.

Step 4: The fund manager commences the sales process for the investment fund and is able to raise $100 of private capital for the fund. Treasury provides $100 equity co-investment on a side-by-side basis with private capital and will provide a $100 loan to the Public-Private Investment Fund. Treasury will also consider requests from the fund manager for an additional loan of up to $100 to the fund.

Step 5: As a result, the fund manager has $300 (or, in some cases, up to $400) in total capital and commences a purchase program for targeted securities.

Step 6: The fund manager has full discretion in investment decisions, although it will predominately follow a long-term buy-and-hold strategy. The Public-Private Investment Fund, if the fund manager so determines, would also be eligible to take advantage of the expanded TALF program for legacy securities when it is launched.

** These samples are provided by the Treasury Department Fact Sheet on the Public-Private Investment Program, https://www.treasury.gov/press-center/press-releases/Documents/ppip_fact_sheet.pdf. Additional details about P-PIP and all the programs implemented by the Administration in response to the economic crisis can be found at http://www.financialstability.gov.*