Date: September 22, 2008

To: Interested Persons

Re: US Treasury Proposal Regarding Troubled Assets

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On Saturday, September 20, the US Treasury sent Congress a draft of proposed legislation which would permit the US Treasury to set up a program to purchase troubled assets from financial institutions. Over the weekend, Congress and many others have been commenting on, studying and negotiating the text that the US Treasury sent to Congress. In addition, the White House has made statements about the plan, as has Secretary Paulson, in press releases, speeches and other television appearances. As some form of the proposed plan is expected to pass during the course of this week, it is evident that there will be almost daily movement as the bipartisan compromise is reached. Lobbying by all interested segments in the US and internationally can be expected to be intense and we also expect international diplomatic efforts. The situation remains fluid and a number of important players are sending mixed signals. The purpose of this memorandum is to delve slightly deeper into some of the technical elements of the plan as proposed by the US Treasury. Readers should be aware that if they are reading this memorandum more than 24 hours after its release it will likely be outdated.

As those who have been reading the press reports no doubt already know, the proposed legislation by the Treasury is short and, at first blush, has a deceptive appearance of simplicity. The current version gives exceedingly broad power to the US Treasury to purchase “troubled assets” from any “financial institution” up to an amount outstanding at “any one time” not to exceed $700 billion. The Secretary is required to take into consideration the stability of the financial markets and the banking system as well as the costs to the US taxpayer, two factors that may at any given time balance in opposite directions. Troubled assets in the form of “mortgage-related assets” must have been issued or originated on or before September 17, 2008. In its totality, the text is about two pages long.

Beneath this apparent simplicity, there are numerous uncertainties, some of which have already been clarified, as detailed below, and some of which will be left for future elaboration. Whatever the outcome of this week’s bipartisan discussions, the reality is that the implementation of the Treasury plan will require a significant regulatory rule-making effort and, in essence, a new Treasury-run regulatory edifice will be required to set forth not only the technical details of the plan but also to set up the parameters and limits of the how the Treasury will deal with its extraordinary powers.

Based on the plan as proposed by Treasury, there are three technical elements upon which many will most immediately focus. These are (1) who is eligible to sell assets, (2) what assets are eligible and (3) how the purchase, servicing and sale of the assets will be managed both immediately and over time.

***Who is Eligible to Sell Assets?***

The term "financial institution" was undefined in the Treasury's initial proposal and is not a term of art in US financial regulation. In its first revised version of the proposed legislation, the US Treasury defined financial institution as "any institution including, but not limited to, banks, thrifts, credit unions, broker-dealers, and insurance companies, having significant operations in the United States, and upon the Secretary's determination in consultation with the Chairman of the Board of Governors of the Federal Reserve, any other institution he determines necessary to promote financial market stability."

In a second revised version of the proposed legislation, the US Treasury defined "financial institution" as "(a) any institution including, but not limited to, banks, savings associations, credit unions, broker-dealers, and insurance companies organized and regulated under the laws of the United States or any State, territory, or possession of the United States, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Marianas Islands, Guam, American Samoa, or the United States Virgin Islands, and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government; or (b) any institution that is providing financing secured by Troubled Assets of a Financial Institution."

Despite the differences in text of these proposals, what remains clear is that almost any US institution would likely be eligible to sell assets to Treasury-sponsored vehicles, including: government sponsored enterprises such as Fannie Mae and Freddie Mac, healthy or troubled depository institutions, broker-dealers, insurance companies, and essentially any actor in the US financial sector that the Treasury considers to be either too big or too entangled to fail.

What remains unclear is the extent to which US licensed branches or subsidiaries of foreign financial institutions would be eligible to sell assets. We believe that the US bank, broker-dealer and insurance subsidiaries of foreign financial institutions are intended to be covered by the financial institution term. The status of the US branches and agencies of foreign banks has been the subject of mixed signals. In combination with Secretary Paulson's statements that the Treasury will also ask other governments to engage in a similar plan, it is possible that the lack of clarity in this area is part of the Treasury's diplomatic negotiations with other nations and central banks and is designed to encourage other nations to follow the Treasury lead.

### *What Assets are Eligible for Purchase and Resale?*

The original proposed legislation was limited to "mortgage-related assets." Both subsequent versions expanded that class to all "troubled assets," including "mortgage-related assets." All mortgage-related assets must have been originated or issued before September 17, 2008, the first day that the Treasury began to talk about its plan. The definition is broad enough to include mortgage loans, mortgage-backed securities, collateralized debt obligations (or CDOs) where the underlying collateral is related to mortgages, and presumably many derivative contracts as well. It would not, however, appear to cover other financial instruments that have caused large losses or concern in the current environment such as (i) CDOs where the underlying collateral is not real-estate related, (ii) credit default swaps, which effectively are credit insurance on the debt obligations of a reference entity, (iii) auction-rate securities, (iv) student loans or (v) leveraged loans that were provided by banks to private equity portfolio companies on terms that are no longer marketable following the credit crunch and have not been syndicated.

In addition to "mortgage-related assets," the term "troubled assets" includes any other financial instrument that "upon the determination of the Secretary, in consultation with the Chairman of the Board of Governors of the Federal Reserve . . . the purchase of which the Secretary determines necessary to promote financial market stability." This second prong of the "troubled assets" definition is broad enough to include any of the non-mortgage-related assets listed above, as well as any other financial instruments that have not yet, but could still, be considered "troubled" and any financial instruments issued after September 17, 2008.

### *How Will the Purchase and Sales of the Assets be Managed?*

Despite some early references in the press that the Treasury plan would be modeled on the Resolution Trust Corporation created during the US savings and loan crisis of the late 1980s and early 1990s, the text as proposed is, in fact, quite different. Rather than setting up one large institution to be the receiver or conservator of failed institutions or to manage all of the bad assets, the Treasury contemplates establishing multiple vehicles or designating financial institutions as financial agents of the United States. The contemplated vehicles may themselves issue obligations. The financial institutions that may be designated are the same institutions eligible to sell assets.

It is quite clear that the Treasury intends to rely very significantly on the private sector to help it buy, manage, service and resell the troubled assets. In the fact sheet, the Treasury implied that all of the purchased assets will be managed by private asset managers at the direction of the Treasury in line with program objectives that the Treasury will presumably establish by rule or individual contract. While it is to be expected that there will be some resistance to the idea that the very financial sector that contributed to the problem will benefit from its clean up, the reality is that the Treasury will need experienced financial services experts, many of whom would be unavailable at government contract rates. The Treasury may enter into service contracts, presumably for managing the assets and the use of financial, accounting and legal experts without regard to the normal contracting rules of the US government.

### *$700 Billion Cap*

The proposed legislation is unclear as to whether the $700 billion cap is a cap on the cumulative amount of troubled assets that the Treasury has the power to purchase (regardless of whether it is able to resell purchased assets for a profit or loss or holds them to maturity) or only a limit on the amount of purchased assets that may be "outstanding at any one time," making it a sort of revolving purchase facility. If this uncertainty is not clarified in the text or legislative history of the proposed legislation, the Treasury will be free to resolve the ambiguity itself, arguably without any judicial review as described below.

### *Valuation Issues*

There are also numerous questions related to how the purchase price of the troubled assets will be accounted for, whether the Treasury will permit others to take equity interests in the vehicles, and how the Treasury will run its auctions, purchases and resales in a manner that minimizes the cost to the US taxpayer. For example, the US Treasury could, to avoid concerns that this program will create further moral hazard, set prices that are at a discount to current prices of the securities to extract some pain from participating financial institutions. If it does so, under current US accounting rules (Financial Accounting Statement No. 157), financial institutions will need to "mark to market" their similar positions, causing further writedowns and continuing the problems that are already extant. If the Treasury purchases assets based on current market prices, the taxpayers could be exposed to further risk of loss (or gain) to the extent that the housing market continues to weaken (or reverses) and these securities decline further (or appreciate) in value.

### *The Scope of the Limits on Judicial Review*

As proposed, the only limits on the Treasury's powers are the requirement that it begin reporting to the Congressional committees within three months after its first purchase of troubled assets and semi-annually thereafter. Decisions by the Secretary are non-reviewable by any state or federal court or any other administrative agency. Prohibiting juridical review is a somewhat extreme provision, perhaps permissible where there is no law to apply, but found impermissible where it constitutes an inappropriate delegation of rule-making to an executive agency. The provision will likely be supported on the basis that emergency action is necessary and court review would slow it down. However, the provision is likely to be part of the basis of any challenge to this legislation, or to any action taken under it, by those who feel injured, perhaps including financial institutions that believe themselves to be competitively affected, or other institutions who wish to access the fund.

***Sunset***

The Treasury's extraordinary authority will terminate in two years, although the Treasury will continue to have the power to fund and manage troubled assets that it holds on the termination date.

***Larger Political and Regulatory Implications***

Sometimes events are too large for instant analysis and, in our view, this is one of them. We offer up, however, two preliminary thoughts on some of the larger regulatory implications.

First, despite the best efforts of the White House and the Treasury to keep "partisan pet projects" out of the legislation, a plan that bails out the financial sector without offering some express relief to homeowners facing difficulties is likely to face stiff resistance in some quarters. In fact, the latest version of the Treasury proposal includes foreclosure mitigation provisions that would under certain circumstances require the Treasury to require loan servicers of purchased residential mortgages to enter into sustainable modifications (such as term extensions, rate reductions or principal writedowns) to avoid preventable foreclosures.

Second, both the Treasury and the White House have re-emphasized the longer term need for a complete overhaul of the US financial regulatory system while noting that it is an agenda for another day. The Treasury is naturally pushing its previously published blueprint for reform which recommends creating "a new objectives-based approach to regulation that includes a market stability regulator, a prudential regulator, and a business conduct regulator that focuses on consumer protection." As many who follow this area know, the Treasury blueprint has not previously received widespread support from Congress and the other financial regulators. That said, it is now clear that the current US system, primarily constructed before the Second World War, needs to be modernized. We believe, that unlike the rushed passage of the Sarbanes-Oxley Act, in which Congress and the President did not seem to consider the impact of the legislation on the international scene, in the next phase of structural reform, Treasury, the White House and Congress are likely to be more sensitive to multilateral solutions and engaging in compromises with foreign financial regulators.

We will continue to monitor developments and issue additional newsflashes and memoranda as facts dictate.