

# The Financial Stability Plan and its Impact on Financial Institutions and Private Capital

February 17, 2009

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The US Treasury Department’s Financial Stability Plan (the “Plan”), as announced by Treasury Secretary Geithner on February 10, 2009, and as further elaborated in his congressional testimony over the following 48 hours, has four pillars. It reshapes the ground rules for capital injections into financial institutions, now termed the “Capital Assistance Program,” increases the size and scope of a previously announced non-recourse lending facility by the Federal Reserve to potentially reach \$1 trillion, launches the idea of a public-private investment fund to purchase legacy or toxic assets from financial institutions, and sets aside \$50 billion for homeowner assistance to be fleshed out shortly. Altogether, the Plan may inject more than \$2 trillion into the nation’s financial system, composed of the remaining \$350 billion of Troubled Assets Relief Program (“TARP”) funds and support from the Federal Reserve and anticipated private capital investments.<sup>1</sup>

The Secretary’s diagnosis for the financial system is stark: it is currently “working against recovery.” The new Obama administration intends to “arrest this dangerous dynamic” and “clean up and strengthen” financial institutions, by using, most notably, a “stress test” to be applied for diagnosing financial institutions’ financial health, and offering financial assistance. Any assistance will come with new conditions attached. As has been widely noted, the Plan is long on aspiration but short on details. This memorandum describes the Plan and sets forth some of the issues the government and the private sector will face over the coming weeks as the rest of the Plan takes shape.

Davis Polk will monitor new developments, and will issue newsflashes and memoranda as appropriate once further details concerning the Plan’s components become available.

<sup>1</sup> See David Cho, *Geithner Takes Plan to Global Leaders Secretary Reassures Counterparts about U.S. Rescue Strategy*, WASHINGTON POST (Feb. 15, 2009).

**The Plan's Diagnostic Toolkit**

- » **Mandatory stress test for all banking institutions with assets in excess of \$100 billion**
  - Conducted through coordinated supervisory review by the Fed, FDIC, OCC and OTS
- » **Increased transparency and disclosure**
  - Working with bank supervisors, the SEC and accounting standard setters

**“Clean-Up” of Financial Institutions**

***Diagnosing the Current State of Financial Institutions***

Treasury highlighted general uncertainty regarding lender financial health as a key bottleneck in the road to economic recovery. Disclosure is a first step in the Obama administration’s implementation of the Plan. The key component of Treasury’s “diagnostic toolkit” is stress testing.

***Stress Testing.*** The Plan mandates coordinated supervisory review of financial institutions by “all relevant financial regulators” – namely the Federal Reserve, the Federal Deposit Insurance Corporation (“FDIC”), the Office of the Comptroller of Currency (“OCC”) and the Office of Thrift Supervision (“OTS”). The central diagnostic tool in the Obama administration’s “medical” kit for determining the condition of the ailing financial system will be forward-looking “stress testing” intended to reveal a “coordinated, accurate and realistic assessment” of balance sheet risk exposures.

The Plan imposes a mandatory comprehensive “stress test” on all banking institutions with assets in excess of \$100 billion, regardless of whether they seek to participate in the Capital Assistance Program. It is not clear whether Treasury will require stress tests for smaller financial institutions. The *Wall Street Journal* reported that “people familiar with the matter” said federally insured institutions with less than \$100 billion of assets may voluntarily submit to the comprehensive review.<sup>2</sup>

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Although “stress testing” is a term of art in the financial services and risk management realm, the sense in which Treasury is using it for the Plan is unclear. Typically stress testing involves statistical analysis of an institution’s risk exposure and financial viability under various economic scenarios, particularly including worst-case market conditions. Stress testing is an element of the risk-based approach taken by Basel II and has been used as a

<sup>2</sup> Damian Paletta, *Reviews, ‘Stress Tests’ May Reveal Deeper Bank Troubles*, WALL STREET JOURNAL (Feb. 10, 2009).

### *The New York Times Article on Stress Testing*

» **Bank regulators have already “descended on” 18 of the largest financial institutions to begin the stress testing process**

- An “administration official” said “regulators were also discussing whether to apply the test to small and midsize banks”

» **“Government officials close to the situation” said stress testing could differ in several ways:**

- Assess 2 years of potential losses, rather than just 1 year
- Make “worst case” assumptions when running scenario analyses
- Take a closer look at off-balance sheet items such as derivatives

» **Stress testing results are not expected to be made public for every institution**

Source: Eric Dash, *Bank Test May Expand U.S. Regulators’ Role*, NEW YORK TIMES (Feb. 12, 2009)

supplement to value at risk analysis, which is now widely acknowledged to fail to account for extreme “tail risk” scenarios.

Given that stress testing is not a new concept, the implication is that these reviews would somehow impose more rigorous analysis than applied in the past. See the sidebar for a report from the New York Times on possible stress testing details, based on discussions with anonymous government sources.

In conducting these stress tests, it is unclear whether regulators will use the institutions’ existing internal models. Regulators could modify existing internal risk management models to run a more extreme scenario analysis or regulators could request raw data from the institutions and implement their own standard stress testing model across the industry. It remains to be seen which approach supervisors will adopt.

The Plan frames stress testing as the first step in the Capital Assistance Program (discussed below). Treasury’s stated purpose for the stress testing is to assess “whether major financial institutions have the capital necessary to continue lending and to absorb the potential losses that could result from a more severe decline in the economy than projected.” If Treasury determines through stress testing that the financial institution is insufficiently capitalized, it will then assess whether and how much capital a financial institution must raise, or alternatively obtain via the Capital Assistance Program. This suggests that stress testing will not be used as a “pass/fail test,” but rather will be an indicator of the necessity for further capital injections.

**Stress testing will apparently not be used as a “pass/fail test”**

Some financial institutions fear that stress testing – especially using the “worst case” assumptions that Treasury is focused on – could spur investor flight and further stock price declines. However, several industry groups, including the American Bankers Association, claim the disclosure afforded by stress testing could actually quell public concern over these institutions’ financial health.

**Public Disclosure of Financial Health.** The Plan contemplates, but does not detail, ongoing measures to further enhance public disclosure of financial health. The Plan calls for general coordination among Treasury, bank supervisors, the Securities and Exchange Commission (“SEC”) and accounting standard setters to improve financial institution disclosure norms. Treasury states that “increased transparency will facilitate a more effective use of market discipline in financial markets.”

Treasury stated that it explicitly recognizes “the need not to adopt an overly conservative posture or take steps that could inappropriately constrain lending.”

This may be a response to industry concerns that mark-to-market accounting across all asset classes may incentivize institutions to “hoard capital” rather than increase lending and re-stimulate the economy. Indeed, one possible conundrum resulting from the new stress testing exercises described above might be the necessity for financial institutions to recognize – and thus disclose – losses more rapidly.

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A number of questions are raised by the concept of enhanced and probably more frequent disclosure. While it seems obvious that the SEC’s Statistical Guide to Bank Holding Company disclosure (“Guide 3”), first adopted in 1971 and lightly modified in 1987, has long needed updating, despite numerous attempts to do so, the SEC staff has failed to reach a consensus on the appropriate changes. In the meantime, financial institutions’ disclosures have moved far beyond Guide 3’s focus on loans and deposits. Consider, for example, the Federal Reserve’s Market Risk Disclosure Rule, the recommendations of Basel’s Pillar 3 and the norms of the International Financial Reporting Standards, as well as recommendations by other international bodies such as the Financial Stability Forum and the Senior Supervisors Group, which is composed of the Federal Reserve, the OCC, the SEC and regulatory agencies from France, Germany, Switzerland and the United Kingdom. It is also to be expected that the G-20 will take up this issue at its meeting in April.

Despite all of the market best practices and international recommendations, adopted in the vacuum of US regulatory inaction, it is clear that financial institution disclosure is not all that it ought to be. Undisclosed items included the residual risk of off-balance sheet vehicles, credit default swaps and other derivatives, counterparty risk and, perhaps most fundamentally, liquidity risk. A fundamental issue to work through will be the comparability and timing of disclosures across major international financial institutions. There is also a question whether US regulators, acting alone, will be able to shape new norms for international financial institution disclosures without convergence of requirements with at least a quorum of the regulators of major foreign financial institutions. In sum, political calls for more disclosure in the current

environment disguise the complexity of the issues that will have to be sorted out in order to arrive at a functional solution.

Treasury's reference to coordination with "accounting standard setters" may imply a continued focus on mark-to-market accounting issues. Mark-to-market accounting has recently been a controversial topic of debate among legislators and accounting circles alike.

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Lawmakers have called on the SEC to investigate the impact of mark-to-market accounting on recent financial institution failures and the dramatically shrinking balance sheets

of financial institutions. In its report to Congress, the SEC advised against the suspension of mark-to-market accounting but encouraged the development of additional guidance for determining the fair value of assets in inactive markets.

Proponents of mark-to-market accounting maintain that it provides transparency of financial institution balance sheets and is helpful in identifying problem assets. Critics argue that mark-to-market accounting has contributed to a downward spiral that forced financial institutions to record massive writedowns, leading to further asset devaluations, increased distressed sales and significant reductions in regulatory capital, which thereby constrained lending capacity. Critics also question the appropriateness of mark-to-market accounting for illiquid assets for which no actual market value exists, requiring resort to models to estimate market value. These massive writedowns also purportedly triggered the recent free-fall in stock prices of financial institutions.

The commentary surrounding the debate of mark-to-market accounting has drowned out another accounting practice that has been equally controversial in the past, the concept of "dynamic provisioning." As described by the Bank for International Settlements, under dynamic provisioning a financial institution would "estimate ... the long-term average losses from defaults ... lead[ing] to comparatively higher levels of provisioning on loans with relatively high average default rates."<sup>3</sup> Such "counter-cyclical provisioning" effectively smoothes losses by preemptively reserving for losses during upticks of the

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<sup>3</sup> Claudio Borio & Philip Lowe, *To Provision or Not to Provision*, BIS QUARTERLY REVIEW, 40 (September 2001).

### ***The Bank of Spain on Dynamic Provisioning***

- » **The Governor of the Bank of Spain listed a number of motivating factors for Spain's adoption of dynamic provisioning:**
  - Past supervisory experience suggested that financial institutions, caught in a wave of exuberance during good economic times, relaxed their credit standards only to suffer severe contraction in financial performance during subsequent market downturns
  - Such "pro-cyclical" behavior distorted financial institutions' perceptions of their own financial standing and risk exposure, leading them to generously distribute profits during good economic times rather than sufficiently reserve capital for market downturns
- » **Initially, Spanish financial institutions opposed the provision as creating an uneven playing field with international competitors that used mark-to-market accounting and thus had lower reserves and higher lending capacity**
- » **Eventually, Spanish financial institutions came to appreciate that [dynamic provisioning] helped strengthen their solvency and, therefore, their medium-term attractiveness and resilience**

economic cycle, rather than taking sudden asset writedowns when credit conditions deteriorate.

Dynamic provisioning is not without its detractors, however, and has long been frowned upon by the SEC staff, which views the practice as "earnings management." Since financial institutions are required to take a charge to their net income based on their own estimates of default losses, dynamic provisioning allows a great deal of discretion to financial institutions. In the late '90s, US banking regulators and staff at the SEC reached an accord, at the insistence of the SEC staff, which discouraged dynamic provisioning.<sup>4</sup>

In sharp contrast, since 2000, the Bank of Spain has encouraged its financial institutions to engage in dynamic provisioning. (See sidebar for a discussion of the Bank of Spain's motivation for and experience with dynamic provisioning.) As a result, Spanish financial institutions' earnings were heralded as comparatively well-performing and less prone to market volatility during the fall of 2008. With dynamic provisioning in place, Spanish financial institutions began 2008 with more than 200% coverage of nonperforming loans, as compared to an average of only 58.6% for all other European Union financial institutions in 2006. More recently, the Spanish economy has entered into its own severe recession and mortgage crisis. Nonetheless, given the relative success of Spanish financial institutions, dynamic provisioning is now on the agenda of both the Bank of England and the Financial Crisis Advisory Group. The Financial Crisis Advisory Group was established in December 2008 by the International Accounting Standards Board and the US Financial Accounting Standards Board to assemble a think tank of international business and government leaders to consider financial reporting issues arising from the current global financial crisis.

In a recent report, the Financial Stability Forum suggested means for improving dynamic provisioning to create sound loan-loss provisioning, in order to allay the fear that financial institutions would use the inherent discretion in dynamic provisioning as an "earnings management" technique. The Financial Stability Forum said it would "examine how judgment is used in existing accounting standards to build sound, robust provisioning levels consistent with the credit losses inherent in their loan portfolios; and whether, in a longer term perspective, changes in accounting standards and the capital regime can

<sup>4</sup> See FEDERAL RESERVE BULLETIN Vol. 85 Num. 9 (Sep. 1999) at p.634.

promote more effective through-the-cycle provisioning consistent with providing transparency with respect to changes in credit trends.”

All of this suggests that consideration of both mark-to-market and dynamic provisioning will be part of the further discussions about the Plan at Treasury.

### ***Bolstering Capital – the New “Capital Assistance Program”***

Institutions that are viewed as having inadequate capital buffers as a result of the stress testing exercise will be encouraged by Treasury to raise capital. They will also be eligible to issue convertible preferred stock to Treasury under the newly established Capital Assistance Program. Those financial institutions that are not subject to a mandatory stress test will be eligible to obtain capital under the Capital Assistance Program after a supervisory review, the terms of which are not yet known. Unlike the Capital Purchase Program under TARP, which was intended to provide capital to strong and solvent financial institutions, the Capital Assistance Program is described as a backstop source of capital, apparently intended to serve as a “last resort” when private markets are not functioning properly. Until private investors rediscover interest in financial institutions, however, the outcome may well be similar to that under the Capital Purchase Program, as the government’s investment will often remain the only available source of capital. The full terms of the preferred stock to be issued under the Capital Assistance Program are not yet available, but the fact sheet released by Treasury (the “Fact Sheet”),

other public information and public statements by the Secretary provide the following information and to-be-determined items.

***Purchase Price.*** Although Treasury has not released the terms for the Capital Assistance Program preferred shares, the Secretary stated that they “should encourage the institutions to replace public assistance with private capital as soon as that is possible.”

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The terms of the Capital Assistance Plan preferred shares should, according to the Secretary, encourage issuing institutions to “replace public assistance with private capital as soon as that is possible”

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***Convertibility.*** Unlike the Capital Purchase Program, institutions participating in the Capital Assistance Program will have the right to convert their Treasury-held preferred shares into common stock as needed to ensure that firms have the capital strength “to preserve lending in a worse-than-expected economic environment.” The conversion price will be set at a “modest discount” to the

institution's common stock price as of February 9, 2009. This mandatory convertibility feature makes the preferred stock a good source of potential common equity, or "contingent equity," at a price that may end up being favorable for the issuing institution, while reducing the dilution to existing shareholders as compared with immediate common stock purchase by Treasury or a delayed purchase at a discount to the market price of the common stock at the time of the purchase.

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Because the equity component of the convertible preferred stock will be accounted for as additional paid-in capital, the convertible preferred stock is also responsive to one of the criticisms of the preferred stock issued under the Capital Purchase Program. The criticism was that while the non-convertible Capital Purchase Program preferred stock was treated as Tier I capital, it was senior to participating institutions' common equity and, therefore, such institutions' financial ratios vis-à-vis their capital stock were and remain low.

**Redemption.** As the terms of the Capital Assistance Program have not yet been released, it is unclear what conditions, if any, institutions issuing preferred shares under the program must satisfy to redeem those shares. The theme of the Capital Assistance Program – to provide a "bridge" to private capital to support institutions that do not meet the stress test – suggests that there will likely be few, if any, redemption conditions. In addition, the American Recovery and Reinvestment Act of 2009, which President Obama is expected to sign into law on the date hereof, amends the Emergency Economic Stabilization Act of 2008 to allow any institution participating in TARP to repay any previously received TARP assistance, subject to consultation with the primary federal banking regulator, without regard to whether the institution has replaced such assistance with funds from any particular source or complied with any waiting period. This provision overrides the terms of Capital Purchase Program investments, under which institutions cannot redeem their Treasury preferred stock within the first three years except with offerings of common stock and/or Tier I qualifying perpetual preferred stock raising aggregate gross proceeds of at least 25% of the issue price of the Treasury preferred. This provision would presumably also apply to Treasury investments via the Capital Assistance Plan. When TARP assistance is repaid,

the American Recovery and Reinvestment Act of 2009 requires the Secretary to liquidate warrants associated with such assistance at the current market price.

**Asset Ownership.** As part of Treasury's new disclosure and accountability procedures, all investments made under the Capital Assistance Program will be placed in a separate trust – the Financial Stability Trust – that will be established to manage the government's investments in US financial institutions, including, possibly, previously made investments under TARP such as Capital Purchase Program preferred shares.

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The American Recovery and Reinvestment Act of 2009 allows any institution participating in TARP to repay assistance without certain impediments previously imposed

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**Common Stock Voting.** It is unclear whether, as with the warrants Treasury obtained under the Capital Purchase Program, the Financial Stability Trust will agree not to vote any common stock it may hold.

**Available Funds.** On a “back of the envelope” calculation, Treasury has approximately \$350 billion – the second half of the funds allocated by Emergency Economic Stabilization Act of 2008 – available for the Plan. According to the Fact Sheet, Treasury has allocated \$100 billion to the Term Asset-Backed Securities Loan Facility and \$50 billion to foreclosure mitigation, leaving Treasury \$200 billion to allocate between the Capital Assistance Program and the Public-Private Investment Fund discussed below.

**Requirements for Issuing Institutions.** To issue preferred shares under the Capital Assistance Plan, institutions will be required to comply with certain requirements discussed in the following section.

### Monthly Reporting Requirements for Recipients under the Capital Assistance Program

- » **Disclose lending activities, including:**
  - New loans
  - Number of asset-backed and mortgage-backed securities purchased
- » **Estimate what lending would have been in the absence of government support**
- » **Description of the lending environment in which the firm operates**

### *Government Assistance as Privilege – Conditions Attached*

TARP has been subjected to increasing criticism for a lack of transparency and oversight. In an effort to restore legislative and public support, the Plan promises to call for “greater transparency, accountability and conditionality.” According to the Secretary, “access to public support is a privilege, not a right. . . . Government support must come with strong conditions to protect the taxpayer and with transparency that allows the American people to see the impact of those investments.” The Plan, therefore, includes new reporting requirements and conditions for assistance that will apply prospectively.

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Some of these new requirements and conditions, in particular certain new reporting requirements, are “informed” by recommendations made by formal oversight bodies, including the Congressional Oversight Panel, the Special Inspector General for the Troubled Asset Relief Program (the “Special Inspector General”) and the Government Accountability Office, as well as Congress, the press and the public.

**Reporting.** As part of the application process, firms that receive funds from the Capital Assistance Program or “exceptional assistance” will be required to submit a plan describing how the additional capital will preserve and strengthen their lending capacity. Such firms will also be required to submit monthly reports to Treasury, as detailed in the sidebar. Public companies will be required to submit similar reports on a Form 8-K simultaneously with their quarterly and annual filing, *i.e.* on a quarterly basis. This requirement appears duplicative based on Treasury’s commitment to make all monthly reports available on the Internet, discussed more fully below.

Requiring monthly reports from all institutions that receive future capital investments is consistent with a recommendation made by the Government Accountability Office. The report as described by Treasury appears to share similarities with a monthly lending activity survey that Treasury submitted in January to the recipients of the twenty largest investments under the Capital Purchase Program, and does not request information concerning corporate expenditures that would be required by a bill currently pending in the House Financial Services Committee.

**Conditions Imposed on Plan Recipients**

- » **Mandatory participation in mortgage foreclosure mitigation programs**
- » **Restricting dividends, stock repurchases and acquisitions**
- » **Senior executive compensation restrictions**
- » **Lobbyist safeguards by prohibiting political interference in investment decisions**
- » **Posting contracts and investment information on the Web**

It remains to be seen whether the Plan will incorporate other recommendations made by formal oversight bodies, such as a requirement that future capital investment agreements include a requirement that the institution track and report the use of the funds. In its recent capital investments in Citigroup and Bank of America, Treasury required each of those institutions to use its best efforts to track the government funds, to establish internal controls and to report on a quarterly basis as to how the funds are being used. Citigroup recently released its first quarterly report on its use of government capital.

*Other Conditions.* All recipients of future capital investments will be required to participate in mortgage foreclosure mitigation programs consistent with Treasury guidance. See “Outlook – Housing Support & Foreclosure Prevention” for further discussion.

Davis Polk has separately prepared a client memorandum entitled [Compensation Provisions in the American Recovery and Reinvestment Act of 2009](#) dated February 17, 2009, regarding compensation restrictions to which such recipients will also be subject. These restrictions may be in addition to, or may supersede, the compensation restrictions announced by Treasury on February 4, 2009, which were discussed in the Davis Polk client memorandum entitled [New Executive Compensation Restrictions under the Emergency Economic Stabilization Act of 2008](#) dated February 6, 2009.

Other additional restrictions apply until the government is repaid. For example, financial institutions that receive “exceptional assistance” will be unable to declare a quarterly dividend per common share above \$0.01, while those that receive “generally available capital” may request that Treasury and their primary regulator approve a higher amount. The restrictions on dividends by institutions receiving “exceptional assistance”

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are similar to those found in the capital investments in Citigroup and Bank of America announced in November 2008 and January 2009, respectively. Moreover, financial institutions that receive funding under the new Capital Assistance Program will also be restricted from repurchasing any “privately-

held shares” absent approval by Treasury and their primary regulator. By way of comparison, under the Capital Purchase Program, Treasury consent is required for most repurchases of junior shares for three years from the date of the government’s investment. Lastly, all financial institutions that receive capital assistance are restricted from pursuing cash acquisitions of “healthy” firms until the government investment is repaid, although exceptions will be made for “explicit supervisor-approved restructuring plans.” As announced, the Plan does not include restrictions on stock acquisitions.

***Enhanced Public Disclosure of Government Action.*** A major theme in Treasury’s statements in connection with the Plan is the importance of increasing the transparency of the investments made by the government as well as of the efficacy of the Plan’s initiatives.

On January 28, 2009, after a request from the Special Inspector General, Treasury announced that it would begin posting contracts for transactions related to TARP within five to ten business days. Treasury stated that the goal of the new policy was “that taxpayers can see how their money is being spent and the terms these institutions must agree to before we invest taxpayer money.”

Treasury plans to further its initiative to increase transparency and accountability to the public through the creation of a new Website, <http://www.FinancialStability.gov>. In addition to the contracts under the Plan,

Treasury will make public the value of its investments, the quantity and strike price of warrants received, the schedule of required

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payments to the government and comparison to the terms and pricing of recent market transactions, where available. Furthermore, Treasury will also post “[a]ll information disclosed or reported to Treasury by recipients of capital assistance,” as well as metrics published by Treasury and banking regulators concerning the impact of the Plan on credit markets. The extent to which this disclosure will go beyond the application for assistance and the monthly reports is not clear.

### *Sale of Legacy Assets*

The Secretary acknowledges that there is a strong need to purge the financial institutions' balance sheets of the legacy assets obtained during the asset bubble, noting that these "real estate related assets are at the center of this crisis."

In order to provide incentives for private capital to invest in financial institutions, and to more broadly restore trust in the financial sector, different approaches had been

discussed in Washington. One

approach was to ring-fence certain legacy assets on financial institutions' balance sheets and have the government assume the

While the aggregator bad bank proposal would achieve the goal of cleansing the banks' balance sheets, it has been stalemated by disagreement over how to value the illiquid assets to be purchased

"tail risk" on those assets, similar to the approach used for certain assets of Citigroup and Bank of America in November 2008 and January 2009, respectively.

An alternative also discussed involved the creation of an "aggregator bad bank," which would use public funds to purchase legacy assets from financial institutions, at a price determined by the government. While the aggregator bad bank proposal would achieve the goal of cleansing the banks' balance sheets, it has been stalemated by disagreement over how to value the illiquid assets to be purchased. If the valuation of the assets is set too low, financial institutions may choose not to participate, keeping the legacy assets on the balance sheet, or incur unnecessarily large writedowns. Alternatively, if the price for the assets is set too high, it could be seen as a windfall for the financial institutions and place a large burden on the taxpayer to resolve the losses on the assets.

A final approach is the traditional good bank/bad bank structure, which has been used successfully in many countries, including the United States. There are many variations of this structure, but they all have the following fundamental elements. Each bank holding company with a troubled bank subsidiary creates a new bank subsidiary for the purpose of purchasing and isolating the "bad assets" from the troubled bank. The new bank is capitalized with enough capital to purchase the bad assets from the pre-existing bank. This capital can come from the bank holding company's existing shareholders or from the government. The new bank purchases the bad assets from the pre-

existing bank at book value, turning the pre-existing bank into a “good bank” and the new bank into a “bad bank.” The FDIC waives the good bank’s cross-guarantee liability to the bad bank in order to insulate the good bank from the bad bank. The government can also assume the tail risk on the bad assets, the way it did with the segregated pool in the Citibank and Bank of America structures. The bad bank can be spun off to shareholders or kept as a liquidating bank within the group. The bad bank hires management that focuses exclusively on maximizing recovery on its bad assets. The good bank can now raise capital from the public markets and resume normal banking practices.

Rather than choosing any of these approaches, Treasury announced a new Public-Private Investment Fund, which adopts some of the aggregator bad bank features, but incorporates an element of private capital participation. The fund is discussed in the following section.

## The Role of Private Capital

### *Joint Investment – The Public-Private Investment Fund*

In an effort to restart the currently illiquid market for legacy assets, the Plan announced the creation of the Public-Private Investment Fund (the “Investment Fund”). Treasury, working together with the FDIC and the Federal Reserve, hopes to adopt this “new approach” to leverage private capital through government capital and financing to purchase up to \$500 billion in assets, with the potential expansion to up to \$1 trillion.

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The Investment Fund approach aims to leverage private capital through government capital and financing to purchase up to \$500 billion in assets, with the potential expansion to up to \$1 trillion

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***Focus on Legacy Assets.*** According to the Plan, the Investment Fund will provide greater means for financial institutions to cleanse their balance sheets of “legacy assets.” The term “legacy assets” should allow purchases by the Investment Fund of the “real-estate related assets” that have been identified by Treasury as being at the center of the financial crisis. However, losses on other types of assets have been growing as well. For example, by some estimates, US companies are expected to default on \$450 billion to \$500 billion of corporate bonds and bank loans over the next two years.<sup>5</sup> It remains to be seen how broadly Treasury will define the assets the Investment Fund will be allowed to purchase.

***Specifics of Private Capital Involvement Unclear.*** The key new feature of the Investment Fund, compared to earlier discussions regarding an aggregator bad bank, is an element of private capital participation. The specifics of this public-private partnership are still unclear. Treasury views private sector involvement as preferable because it would allow “private sector buyers to determine the price for current troubled and previously illiquid assets,” and thus improve price discovery as compared to the aggregator bank proposal where the government is the sole buyer.

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<sup>5</sup> Jeffrey McCracken and Vishesh Kumar, *Wave of Bad Debt Swamps Companies*, WALL STREET JOURNAL (Feb. 13, 2009).

Treasury is considering different structures and plans to seek input from both market participants and the public. It remains to be seen whether pricing mechanisms will indeed be easier to design due to private sector involvement, or whether the same or similar problems to those associated with the aggregator bank structure will become evident. Most certainly, the level of government involvement itself will have a distorting effect on prices, a fact that already may be factored into the government's calculation.

It would also seem that, in addition to public interest considerations that would influence price setting in an aggregator bad bank, such as the impact on taxpayers and financial institution sellers, the Investment Fund will need to attract private capital by offering economic incentives. Private investors will presumably find the program most attractive if it would allow them to purchase legacy assets at low risk and low prices, increasing the likelihood of profit. Low prices may in turn keep some financial institutions from participating and could result in further writedowns.

The *Wall Street Journal* reported that anonymous sources at certain private equity funds and insurers indicate some level of interest in the Investment Fund, although the extent of such interest is unclear.<sup>6</sup> The nature of the government backstop, the size of the program, the securities pricing yielded for financial institutions, the nature of any profit sharing arrangements and other details may ultimately determine how

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The features of the Investment Fund may ultimately determine how attractive the Investment Fund will be to investors and financial institutions

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attractive the Investment Fund will be to investors and financial institutions. The Secretary commented that the Investment Fund is a work in progress, and that, "we're going to do this carefully, consult carefully, so we don't put ourselves in the position again" where there are "quick departures and changes in strategy."

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<sup>6</sup> Peter Lattman, Scott Patterson and Serena Ng, *Wall Street Criticizes 'Bad Bank'*, WALL STREET JOURNAL (Feb. 11, 2009).

### **General Terms of the Term Asset-Backed Securities Loan Facility**

- » **New York Fed to extend non-recourse loans of up to \$200 billion, increased, after a first phase of operations, to a maximum of \$1 trillion, to fund purchases of asset-backed securities**
- » **Treasury to provide first loss protection to New York Fed of initially up to \$20 billion, to increase to a maximum of \$100 billion after the first operational phase**
- » **Initial subscription date will be announced in February 2009 and is expected to occur in March 2009**
- » **Eligible collateral consists of highly rated asset-backed securities backed by new or recently originated consumer and small business loans, to be expanded to include commercial mortgage-backed securities and possibly other asset classes**

### ***Funding and Backstop to Private Investors – “TALF” and other Federal Reserve Initiatives***

Over the last several months, the Federal Reserve has initiated a variety of programs designed to inject liquidity into markets affected by the financial crisis, whether by acting as buyer for commercial paper, money market fund shares or debt issued or backed by government-sponsored enterprises, or by providing collateralized financing, including in some cases non-recourse lending, to various financial market participants. According to recent testimony by Federal Reserve Chairman Ben Bernanke, together with other initiatives taken concurrently by other government entities such as the FDIC’s Temporary Liquidity Guarantee Program, the programs have had their intended effect of helping to “relax the severe liquidity strains” and fostering “considerable improvements in interbank lending markets.”

One of the markets still awaiting a government-assisted revival is the private label asset-backed paper market. It is this market the Term Asset-Backed Securities Loan Facility, or TALF, is designed to help. Several other markets are targeted by one or more of the other funding programs currently operated by the Federal Reserve.

### **Reviving the Asset-Backed Securities Market – the Term Asset-Backed Securities Loan Facility**

Hardly any market has been more affected by the recent market turmoil than the private label securitization market. The pendulum appears to have swung from a failure of the financial markets to properly recognize and price the huge risks of certain securitization classes, such as subprime-backed mortgages and collateralized debt obligations, to a situation where securities backed by any asset classes not also explicitly or implicitly backed by the government are virtually impossible to bring to the market. While lenders in the residential mortgage market were able to resort to government-sponsored or -backed securitization in the form of Fannie Mae, Freddie Mac and Ginnie Mae issuances and funding via Federal Home Loan Banks, other forms of securitization that lack government backing, such as securities backed by credit card receivables or auto loans have slowed to a trickle. Even certain types of government-backing, such as loans guaranteed by the Small Business Administration, no longer appear to permit access to the securitization markets at sustainable terms.

In November of last year, the Federal Reserve announced a facility to revive the asset-backed securities markets, the Term Asset-Backed Securities Loan

Facility. The facility has yet to start operations and will be administered by the Federal Reserve Bank of New York (the “New York Fed”). The initial subscription date and settlement date will be announced some time later this month, and are expected to occur in March 2009. Under the current terms, the facility will stop making loans on December 31, 2009, unless extended by the Federal Reserve.

The initial subscription date and settlement date will be announced some time later this month, and are expected to occur in March 2009

Many of the terms of the Term Asset-Backed Securities Loan Facility have been available since last year. However, the Plan and a release of revised terms on February 6, 2009 have significantly reshaped the facility by announcing to potentially quintuple its size after a first phase of operations and clarifying under which conditions investment funds can become borrowers of the Federal Reserve. Further clarity was provided during an investor call organized by the Federal Reserve on February 12, 2009.<sup>7</sup>

The reshaping of the facility has in turn spawned a variety of challenges for the Federal Reserve, including concerns that its ability to control monetary policy would be constrained by such an increase in longer-term lending and that dealing with unregulated investment funds invites complications. The terms applicable to funds and other important aspects of the facility are discussed below.

***Core Features of the Term Asset-Backed Securities Loan Facility.*** Under the Term Asset-Backed Securities Loan Facility, the New York Fed will provide non-recourse loans with a term of three years that will be fully secured by certain highly-rated US dollar-denominated cash (that is, not synthetic) asset-backed securities. Borrowers are only permitted to borrow an amount equal to the value of their pledged collateral minus a haircut; however, the precise method for determining the collateral value, whether by reference to the purchase price paid by the borrower or some other method, has not yet been announced. The amount of the haircut varies depending on the type of collateral and the maturity date of the security pledged.

It is currently unclear whether borrowers will only be permitted one fixed rate and one floating rate loan per month, or whether multiple loans will be

<sup>7</sup> A recording of the investor call is available until February 26, 2009 by dialing 1-800-475-6701 and entering code 985211.

permitted to be matched to specific asset classes of permissible collateral. There is no maximum loan amount, but there is a minimum loan amount of \$10 million per loan. For all transactions under the facility, a borrower has to be represented by a primary dealer, as described in more detail below. The Federal Reserve is considering whether to permit loan requests through various primary dealers.

Due to its non-recourse nature, in addition to funding, the facility offers a backstop should losses on the pledged collateral exceed the haircut. There are no margin calls on the loans, meaning that the New York Fed cannot demand additional payments of cash from borrowers if the collateral falls in value.

While borrowers are free to elect to surrender the collateral to the New York Fed in lieu of repayment of their loans, the election cannot be made for specific collateral, but only for the entire pool of collateral, which presumably means the pool securing that particular loan. Should borrowers be permitted to match loans to specific asset classes, as

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currently discussed, it would allow for a more tailored use of the non-recourse feature. If a borrower elects to surrender collateral, the New York Fed will sell the collateral to a special purpose vehicle established specifically for the purpose of managing such assets and to enable a loss sharing arrangement between Treasury, contributing the first loss protection, and the Federal Reserve, bearing any losses in excess of the first loss protection. Although details on how residual returns will be shared between the Federal Reserve and Treasury are not yet available, Federal Reserve Chairman Bernanke has stated that “most of the upside” from the facility, if any, would be allocated to Treasury.

Collateral later found to be ineligible negates the non-recourse feature of the loan, in which case the borrower must replace the collateral or repay the loan. Eligible collateral that subsequently becomes downgraded does not affect the existing loan secured by that collateral, but such collateral may not be used to secure new loans until it regains eligibility. “Fundamental misrepresentations” also negate the non-recourse nature, including failure to authorize a primary dealer as agent, or lack of rights to pledge the collateral.

### Eligible Borrowers

- » Entities organized under US law with significant operations in US
- » A foreign parent's US-organized subsidiaries with significant operations in the US
- » US branches or agencies of foreign banks that maintain reserves with Federal Reserve
- » Investment funds organized under US law and managed by managers with principal place of business in US, including US-organized subsidiaries of foreign entities managed by a US investment manager with a principal place of business in the US
- » Excludes any entity controlled by a foreign government or managed by an investment manager controlled by a foreign government

The Plan, under its “Consumer and Business Lending Initiative,” gives the Term Asset-Backed Securities Loan Facility far greater significance by increasing its maximum lending capacity, after a first phase of operations, from \$200 billion to \$1 trillion, while also increasing Treasury’s first loss piece after that first phase from \$20 billion to \$100 billion, and thus earmarking a significant portion of the \$350 billion of funds left under Congress’ authorization of the second installment of TARP funds. In conjunction with the other measures announced under the Plan, Treasury may soon have to ask Congress for more funds.

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**Investment Funds as Eligible Borrowers.** Borrowers eligible to participate in the Term Asset-Backed Securities Loan Facility include any “US company” that owns or will own eligible collateral as of the settlement date and maintains an account relationship with a primary dealer. The sidebar details the entities included in the definition of “eligible borrower.” Entities controlled by foreign governments, *i.e.*, where a foreign government holds power to vote 25% or more of a class of voting securities, or that are managed by investment managers controlled by foreign governments are excluded.

Significantly, the revised terms and conditions for the Term Asset-Backed Securities Loan Facility released on February 6, 2009 have clarified which “investment funds” qualify as eligible borrowers. “Investment fund” is broadly defined to include any pooled investment vehicle, including hedge funds, private equity funds, mutual funds, and even special purpose vehicles specifically created for investments funded through the facility that satisfy the eligibility requirements. Investment fund structures that are “organized in the United States” with a “principal place of business in the United States” are eligible borrowers. This includes US organized investment fund subsidiaries of a foreign entity and newly established US organized funds as long the funds are managed by a US-based investment manager.

**Compliance Framework.** Although details are not yet available, the facility includes a comprehensive compliance framework overseen by the New York Fed, consisting of, among other features: on-site inspection rights over borrowers, a right to reject a borrower for any reason, and a right to review all loan files held by each borrower’s custodian. In addition to that compliance

## Primary Dealers

### » Screening Function

- Assess borrower risk
- Pre-screen collateral for eligibility
- Provide customer risk assessment methodology to New York Fed
- Communicate high risk information to New York Fed

### » Agent Function

- Collect loan requests, CUSIPs and offering documents of collateral securities
- Submit collected information to New York Fed for review
- Submit aggregate loan requests to New York Fed
- Deliver collateral securities, fee and margin to New York Fed
- Deliver funds disbursed from New York Fed to borrowers

framework, the revised facility also contains other safeguards, including requiring certification from qualifying accounting firms that the asset-backed securities are eligible, and requiring issuers and sponsors to include a signed certification, which covers, among other items, that the sponsor, or any other relevant entity that the New York Fed specifies in future program documentation, has agreed to comply with the executive compensation requirements of the facility. Issuers and sponsors also undertake to indemnify the New York Fed for losses should the certifications be untrue.

**Primary Dealers.** All eligible borrowers must be customers of a primary dealer, which will serve as an agent for the borrower to transact with the New York Fed, which will not directly interface with borrowers. A primary dealer is a bank, securities broker-dealer or other financial institution that has been pre-approved to trade directly with the Federal Reserve, and as of February 16, 2009, there are sixteen institutions on the New York Fed's primary dealer list. Borrowers must execute a customer agreement authorizing the primary dealer to execute the Master Loan and Security Agreement as agent on the borrower's behalf, which has not yet been made public and is expected to provide further detail on the lending terms and will apply to all loans under the Term Asset-Backed Securities Loan Facility.

The mandatory intermediation of primary dealers may help alleviate potential concerns about the inclusion of private unregulated entities by performing a "screening" function for borrowers. Primary dealers must assess borrower risk by applying internal customer identification and due diligence procedures to their customers, as well as communicating information on high risks to the New York Fed. As a further safeguard, the primary dealer must provide an adequate description of its customer risk assessment methodology to the New York Fed. In addition to the screening function, primary dealers are responsible for certain administrative functions outlined in the sidebar.

**Broadened Eligible Collateral.** The Plan broadens the range of eligible collateral under the Term Asset-Backed Securities Loan Facility from securities backed by auto loans, student loans, credit card receivables, and small business loans fully guaranteed by the US Small Business Administration, to also encompass, after an initial phase, commercial mortgage-backed securities. Upon further review, the facility may further allow for collateral in the form of other asset classes such as private-label residential mortgage-backed securities and bonds collateralized by corporate debt.

## Eligible Collateral

### » Security Issuance Dates

- SBA Pool Certificates and Development Company Participation Certificates must be issued on or after January 1, 2008, regardless of the dates of the underlying obligations
- All other eligible ABS must be issued on or after January 1, 2009

### » Origination Dates

- 85% of credit exposures underlying auto loan ABS, except auto dealer floorplan ABS, must have been originated on or after October 1, 2007
- 85% of the credit exposures underlying student loan ABS must have had first disbursement date on or after May 1, 2007
- No origination restrictions for credit card and dealer floorplan ABS, but such ABS must be issued to refinance existing credit card and auto dealer floorplan ABS, respectively, maturing in 2009, and must be issued in amounts no greater than the amount of the maturing ABS

### » Credit Exposures

- 95% or more of the dollar amount of underlying credit exposures must be to US-domiciled obligors
- Credit exposures must be auto loans, student loans, credit card loans, small business loans fully guaranteed as to principal and interest by the SBA and also commercial mortgage-backed securities under the Plan
- Underlying credit exposures may not include exposures that are themselves cash or synthetic ABS

In furtherance of the Federal Reserve's objective of increasing the credit available to domestic consumers and small businesses, for an asset-backed security to be eligible, 95% or more of the dollar amount of the underlying credit exposures of the security must be exposures to US-domiciled obligors.

The sidebar details the conditions eligible asset-backed securities must satisfy as to issuance dates, as well as to origination dates of the underlying loans. Borrowers cannot pledge asset-backed securities for which the borrower or any affiliate originated or securitized any underlying credit exposure.

Prior to the Plan's announcement, it had been speculated that the Term Asset-Backed Securities Loan Facility could be expanded to include toxic or legacy assets. However, the cut-off dates indicated in the sidebar, as well as the ratings requirements applicable to eligible collateral discussed below, mean that legacy assets are not eligible for the facility.

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Legacy assets are not eligible for the Term Asset-Backed Securities Loan Facility

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**Reliance on Ratings.** The Term Asset-Backed Securities Loan Facility, as well as other recent programs by the Federal Reserve rely on private ratings agencies to determine the eligibility of collateral. To be eligible, an asset-backed security must have short-term or long-term ratings in the highest investment-grade category from two or more major nationally recognized statistical ratings organizations and not have a rating by any such rating organization that falls below the highest investment-grade rating.

The Federal Reserve's reliance on credit ratings, in the light of criticism, shared by Treasury, of the agencies' role in the "systematic failures," perhaps signals the Federal Reserve's view that steps by the SEC and the European Union to regulate the ratings industry currently under way will improve the performance of the ratings agencies. More likely, it may merely be an acknowledgment that there is currently no better substitute.

**Pricing and Fees.** Ultimately, to make the Term Asset-Backed Securities Loan Facility a success, the economics have to bring private capital back into the business of buying asset-backed securities. It would seem that in determining the attractiveness of the facility, investors will look both to the cost of funding, including fees, and to the haircuts determining the amount of equity they will have to employ. Both the haircuts and interest rates will be periodically reviewed to fulfill the policy objectives of the facility.

**Preliminary Collateral Haircuts**

Sub-sector	ABS Expected Life (years)						
	0-1	1-2	2-3	3-4	4-5	5-6	6-7
Auto Sector							
Prime retail lease	10%	11%	12%	13%	14%		
Prime retail loan	6%	7%	8%	9%	10%		
Subprime retail loan	9%	10%	11%	12%	13%		
Floorplan	12%	13%	14%	15%	16%		
RV/motorcycle	7%	8%	9%	10%	11%		
Bank Card Sector							
Prime	5%	5%	6%	7%	8%		
Subprime	6%	7%	8%	9%	10%		
Retail Card Sector							
Prime	6%	7%	8%	9%	10%		
Subprime	7%	8%	9%	10%	11%		
Student Loan Sector							
Private	8%	9%	10%	11%	12%	13%	14%
Gov't guaranteed	5%	5%	5%	6%	7%	8%	9%
Small Business Sector							
SBA loans	5%	5%	5%	5%	6%	7%	8%

Loans under the Term Asset-Backed Securities Loan Facility are priced either at a fixed or floating interest rate. Currently, the fixed interest rate is 100 bps over the 3-year LIBOR swap rate and the floating interest rate is 100 bps over 1-month LIBOR. An administrative fee is assessed at 5 bps of the loan amount on the settlement date of each loan transaction.

Both the haircuts and interest rates will be periodically reviewed to fulfill the policy objectives of the facility

The Federal Reserve has published a table of preliminary collateral haircuts based on asset classes and the expected lives of the asset-backed securities. The preliminary haircuts have been set between 5% and 16% out to an expected life of seven years, with a one percentage point increase for each additional year of expected life beyond seven years. See sidebar for details.

The haircuts can also be viewed as a measure of the value of the floor the Federal Reserve is providing to investors via the non-recourse nature of the loan. The riskier the asset pledged and the smaller the haircut, the more valuable the floor is to investors. The preliminary collateral haircuts announced February 6, 2009 have been designed to be risk sensitive across asset class and maturity. Although reportedly under consideration, it remains to be seen whether some form of risk measure by individual asset will ultimately be part of the facility.

**Other Federal Reserve Initiatives**

Several asset purchase programs are currently in operation to inject liquidity into various markets that have been frozen as a result of the ongoing financial crisis. In the Commercial Paper Funding Facility, a special purpose vehicle funded by the Federal Reserve purchases three-month commercial paper from US issuers of commercial paper at a pre-determined rate to provide liquidity to the commercial paper market. The Money Market Investor Funding Facility operates in a similar manner, except that instead of commercial paper, the special purpose vehicle purchases money market assets from US money market mutual funds as well as funds managed or owned by a US bank, insurance company, pension fund, trust company, SEC-registered investment advisor or a US state or local government entity to facilitate sales of money market instruments.

A third purchase program, targeted at housing-related government sponsored enterprises, allows the Federal Reserve to purchase up to \$500 billion in

mortgage-backed securities backed by Fannie Mae, Freddie Mac and Ginnie Mae plus \$100 billion in direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. In a joint statement by the Secretary, Chairman Bernanke and others on February 10, 2009, the Federal Reserve announced that the ongoing purchase program for mortgage-backed securities will continue and that the program may expand in the future should conditions warrant.

Besides purchase programs, the Federal Reserve has also engaged in or expanded lending programs, including non-recourse lending. In addition to the Term Asset-Backed Securities Loan Facility, which is described above, the Federal Reserve, through its Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, makes non-recourse loans to US depository institutions, bank holding companies or US branches and agencies of foreign banks to finance their purchases of high quality asset-backed commercial paper from money market mutual funds.

On February 3, 2009, the Federal Reserve extended the life of several of its liquidity programs – including the Commercial Paper Funding Facility, Money Market Investor Funding Facility and Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility – by six months until October 30, 2009. The Federal Reserve cited “continual substantial strains in many financial markets” and stated that it would keep these programs operating as long as necessary to keep the financial markets stable.

### *Exit Strategies*

Treasury has acknowledged the importance of private capital to long-term financial recovery. The Secretary, in announcing the Plan, stressed that “policies must be designed to mobilize and leverage private capital, not to supplant or discourage private capital. When government investment is necessary, it should be replaced with private capital as soon as possible.” This view is reflected in the characterization of the Capital Assistance Program as a “bridge to receiving increased private capital.”

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Similarly, private capital will presumably be called to step in once credit markets begin to recover and the Federal Reserve will have to unwind several

of its lending programs, which currently contribute to the Federal Reserve's roughly \$1.8 trillion balance sheet.

Moreover, private capital may also be needed to support the mortgage market as Fannie Mae and Freddie Mac reduce their respective mortgage assets by ten percent per year from up to \$850 billion to \$250 billion starting in 2010. This reduction was part of the terms of the commitment by Treasury to contribute up to \$100 billion in cash capital in exchange for senior preferred stock to ensure that both Fannie Mae and Freddie Mac maintain positive net worth.

Despite this recognition, it remains unclear how the government intends to encourage the transition from the current situation where the government is relied upon as a major market

player to one where private markets operate on their own. Currently, potential private alternatives face the prospect of competing with an

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The Secretary has stressed that “action has to be sustained until recovery is firmly established”

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increasingly crowded array of government-backed debt issuances and securitizations. What is clear is that there are limitations to the government's ability to continue to expand its balance sheet. At the same time, the Secretary has stressed that “action has to be sustained until recovery is firmly established” because “previous crises lasted longer and caused greater damage because governments applied the brakes too early.”

The Plan's focus on fostering private capital, particularly through the creation of the Investment Fund, suggests that the new administration may explore exit strategies more proactively.

### *Housing Support & Foreclosure Prevention Plan Includes:*

- » Requiring all Plan recipients to participate in foreclosure mitigation plans
- » Committing \$50 billion of TARP funds to loan modifications
- » Establishing national loan modification standards, to be used by both public and private programs
- » Driving down mortgage rates through up to \$600 billion of New York Fed purchases of government sponsored enterprise mortgage-backed securities and debt
- » Amending HOPE for Homeowners program

## Outlook

Other aspects of the Plan are going to be announced in the coming days and weeks, including information regarding one of the pillars of the Plan, the housing support and foreclosure prevention program.

### *Housing Support & Foreclosure Prevention*

The Plan offered only limited information on the government's much anticipated housing support and foreclosure prevention program. President Obama is expected to personally announce on February 18, 2009, the details of a major foreclosure relief plan, including allocating \$50 billion of the remaining TARP funds on mandatory mortgage modifications. The sidebar details the elements that Treasury has indicated will be part of the Plan.

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President Obama is expected to personally announce on February 18, 2009 the details of a major foreclosure relief plan

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Parallel foreclosure relief proposals are currently being deliberated in Congress. A major change from recent legislative proposals is the requirement that “*all* Financial Stability Plan [r]ecipients [...] participate in foreclosure mitigation plans consistent with Treasury guidance.” [emphasis added] The foreclosure prevention provision included in HR 384, a key bill proposed by House Financial Services Committee Chairman Barney Frank in early January, left open the option of mandating loan modifications on all “participating lenders and servicers.” HR 384 was discussed in the Davis Polk client memorandum entitled [The Struggle Over the Second Half of TARP](#) dated January 12, 2009. In contrast, the Plan makes absolutely clear that all “Plan [r]ecipients” must engage in foreclosure mitigation plans. It is unclear how broadly Treasury defines “Plan [r]ecipients.” “Plan [r]ecipients” may imply a broad variety of institutions, including not only assisted financial institutions but also, for example, investment funds that purchase mortgage backed securities and participate in the Plan through the Term Asset-Backed Securities Loan Facility.

President Obama indicated that the upcoming foreclosure relief plan would require both lenders and borrowers to absorb losses, may include a servicer safe harbor, which would require legislation, and may include shared equity appreciation between borrowers and modifying lenders/servicers. “Shared equity appreciation” means that if the home of an assisted homeowner later

increases in value, that increase in value – *i.e.* increased home equity – would be shared between the homeowner and the modifying lender/servicer upon sale of the home or termination of the mortgage. The *Wall Street Journal* reported that “people familiar with the discussions” suggested that the foreclosure relief plan may include government subsidized reductions in monthly mortgage payments, although Treasury has not confirmed this report. The *Bureau of National Affairs* reported that, according to “a community organization official that was present at the meeting” between the Secretary and industry representatives, another option discussed was direct government purchase of underwater mortgages from investors.<sup>8</sup>

Chairman Frank suggested that parts of the Obama administration's plan could require legislation. Much of the required legislation is already circulating in the House and Senate, but Chairman Frank hopes to pull it all together into a single housing package. The *Washington Post* reported that such required legislation would include not only the servicer safe harbor mentioned by President Obama, but also authority to use TARP funds to pay servicer incentives to modify mortgages as well as a form of bankruptcy cramdown provisions.<sup>9</sup>

The Secretary held meetings on February 12, 2009 regarding the upcoming foreclosure prevention plan with industry representatives and several consumer advocate groups. Both OTS and several members of the House Financial Services Committee Chairman have urged thrifts and other financial institutions to impose a temporary foreclosure moratorium until the Obama administration's foreclosure prevention plan is in effect. Several major lenders have announced three-week foreclosure moratoria with end dates ranging from March 6 to March 12. It is unclear, however, whether the moratoria will affect loans that these lenders securitized and sold to investors in the past.

Several major lenders have announced temporary foreclosure moratoria until the Obama administration's foreclosure prevention plan is in effect

<sup>8</sup> Mike Ferullo, *Government Purchase of Troubled Mortgages Among Options Put to Obama Administration*, BANKING DAILY (a Bureau of National Affairs publication) (Feb. 13, 2009).

<sup>9</sup> Renae Merle and Lori Montgomery, *Democrats Tailor Foreclosure Bill To Obama Goals - Plan Would Change Bankruptcy Law*, WASHINGTON POST (Feb. 14, 2009).

### *Other Developments Ahead*

To date, we are aware of the following upcoming developments:

- **Term Asset-Backed Securities Loan Facility** – The initial subscription date, as well as further details as to documentation and certification requirements, are expected to be announced in February 2009. The timing of the expansion of the facility discussed in this memorandum is currently unknown.
- **U.S. Auto Industry Restructuring** – General Motors and Chrysler LLC are preparing to submit detailed restructuring plans to Treasury on February 17 as required by the terms of the \$17.4 billion dollar aid package they received in December. GM has already received \$9.4 billion in loans and will receive another \$4 billion if its restructuring plan is approved. Chrysler has received \$4 billion and is seeking an additional \$3 billion. GM and Chrysler are also engaged in intense negotiations with bondholders and the United Auto Workers Union to secure concessions required by the aid package. President Obama is preparing to announce an inter-agency committee to oversee the restructuring of GM and Chrysler. The panel will likely be led by the Secretary and Lawrence Summers and will serve in place of the previously announced “auto czar”. The Obama administration has announced that a government-backed bankruptcy remains a viable option.
- **Systemic Risk Regulator Legislation** – House Financial Services Committee Chairman Barney Frank and Senate Banking Committee Chairman Christopher Dodd have publicly supported the creation of a systemic risk regulator to oversee the systemic risks of the financial system. The creation of a systemic risk regulator is believed to be the first priority on Congress’s agenda to overhaul the regulation of the financial services industry. Both Chairman Frank and Chairman Dodd have said that the systemic risk

The creation of a systemic risk regulator is believed to be the first priority on Congress’s agenda to overhaul the regulation of the financial services industry

oversight could be given to the Federal Reserve. A draft plan may be in place by April in time for the G-20 meeting.

- **G-20 Meeting Scheduled for April** – G-20 leaders and representatives from international financial institutions will gather at the London Summit on April 2, 2009. Expected agenda items include global macro-economic coordination, financial sector reform and reform of international financial institutions such as the International Monetary Fund, Financial Stability Forum and World Bank.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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## References

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- » [Financial Stability Plan Fact Sheet](#) (February 10, 2009)
- » [Joint Statement](#) (February 10, 2009)
- » [TALF Press Release](#) (February 6, 2009)
- » [TALF Press Release](#) (February 10, 2009)
- » [TALF Terms and Conditions](#) (February 6, 2009, as updated from time to time)
- » [TALF Frequently Asked Questions](#) (February 13, 2009, as updated from time to time)



*This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.*