Alert: Summary & Update of Economic Stabilization Plan

Now that the federal economic stabilization plan has been signed into law, Steptoe has prepared the following advisory summarizing the key points of the stabilization plan, its implications and likely impacts, in a thoughtful, easy-to-understand analysis.

Executive Summary

After much high drama and suspense, today the President signed into law the "Economic Recovery Amendment to the Paul Wellstone Mental Health Parity Act" (H.R. 1424), an economic stabilization plan that authorizes the Treasury Department to purchase up to $700 billion in "troubled assets" from the nation's financial institutions. The President signed the measure immediately after its passage by the U.S. House of Representatives. The bill had been approved by the Senate earlier this week.

Troubled Assets Relief Program

The legislation authorizes the Treasury Department to establish a Troubled Assets Relief Program (TARP). The theory behind TARP, the economic stabilization plan's centerpiece, is that with problematic mortgage-related investments off their books, banks and other financial institutions will have the confidence to more freely extend credit to each other and to consumers. This theory assumes, of course, that credit is the grease that keeps the gears of the economy running smoothly. The Treasury Department will be given up to two years to make the purchases, and is expected to hold the troubled assets until they could be sold profitably (or with minimal losses) at some future point.

The ability to sell troubled assets to the government will come at a price, however. Most notably, institutions that participate in TARP will have to agree to limits on bonuses and severance pay for top executives. And companies that sell their troubled assets directly to the government will have to give the government equity or debt positions to help offset any losses the government experiences from the troubled assets.

In addition to purchasing troubled assets, the Treasury Department will be able to establish an insurance program for troubled assets modeled on the one for bank deposits administered by the Federal Deposit Insurance Corporation (FDIC), with owners of troubled assets paying premiums in exchange for the government's guarantee that those assets will perform as originally promised.

It should be noted at this juncture that the TARP provisions adopted today are identical to those considered and rejected by the House of Representatives on September 29. Thus, the media reports describing the new law as revamped or tweaked or improved are not completely accurate. The difference between the first version voted on by the House and the measure that was ultimately adopted are the "other" provisions added by the Senate as "sweeteners" to make what is widely regarded as a bitter pill easier to swallow. Among these provisions is a temporary increase in the limit on FDIC guarantees for bank deposit accounts from the current $100,000 maximum to $250,000. The addition of sweeteners is one reason why the bill swelled from the mere three pages initially submitted to Congress by the Treasury Department to a 451 page behemoth.

TARP Oversight

Many of the key specific details of the program, such as what price the government will pay for the assets or how it will define exactly what is a "troubled asset," are to be determined by the Treasury Secretary. But to address criticism that the measure overall gives far too much power to the Secretary, the legislation provides for multiple layers of oversight for the program, including the creation of a new board comprised of the heads of Treasury, the Federal Reserve, Securities and Exchange Commission, Federal Housing Finance Agency, and the Department of Housing and Urban Development. There will also be a Congressionally appointed oversight panel, audits of the program by the Government Accountability Office, and a new Special Inspector General for the program.

In addition, the entire $700 billion purchase authority will not be made available at one time. The legislation authorizes an initial amount of $250 billion to purchase troubled assets. An extra $100 billion is authorized if requested by the President, and the remaining $350 billion can only be used if a request and justification for the money is submitted to Congress and Congress does not disapprove.

Five years after the program's enactment, the Congressional Budget Office and the Office of Management and Budget are to report whether there is a shortfall in the program. If there is a shortfall, the President must present a plan to Congress to recoup the shortfall from the "financial industry." The bill does not specify what type of plan must be offered by the President (e.g., a tax plan).

If TARP makes money, that profit is to be used to pay down the national debt.

Addressing Root Causes of the Economic Crisis

A number of provisions aim to address what many believe to be the root cause of the current economic crisis – homeowners who are unable to pay their mortgages. For example, the law directs the Treasury Department to maximize all opportunities to keep residential mortgages acquired through TARP out of foreclosure, including negotiating (or encouraging loan servicers to negotiate) loan modifications or payment reductions, so long as such efforts do not undermine Treasury's obligation to ensure that taxpayers do not lose money overall on the plan. The law also extends the tax code provision that allows individual taxpayers to exclude mortgage debt forgiveness from their taxable income.

The measure attempts to address concerns that accounting policies recently adopted by federal regulators have exacerbated the economic meltdown. The "mark to market" accounting rule requires companies to record on their balance sheets the amount of money their assets would actually fetch on a given day, even if there is a market failure that means there are no buyers for the asset. Such is the present case for some types of mortgage-backed securities; since no one wants to buy these securities, their market value is nearly zero and must be recorded as such, regardless of the fact that they may continue to have intrinsic value because the underlying mortgages are still performing. The rationale behind the rule was to provide potential investors with an accurate snapshot of an entity's balance sheet. But critics assert that the mark-to-market rule does not work in illiquid markets and has required massive, artificial write-downs of assets by investors, which has led to the cascade of bank failures, takeovers and shotgun mergers.

The new law authorizes the SEC to suspend Fair Accounting Standards Board (FASB) Statement 157, of which the mark-to-market accounting rule is a part, and directs the SEC and FASB to study the effects of mark-to-market. Although it is widely assumed that the SEC already had the authority to suspend the rule, the presence of the FASB Statement 157 suspension provision in the bill is credited with spurring the SEC to issue a "clarification" to the rule earlier this week, and a commitment by FASB to provide further guidance in the very near future. The question of whether the SEC's most recent clarification actually helps clear up matters is subject to much debate, however.

The Sweeteners

Other sections of the law unrelated to TARP add the "sweeteners" that apparently induced enough House members to change their minds and support passage of the stabilization plan, including:

- The extension of numerous popular tax provisions;
- Alternative Minimum Tax relief;
- Tax credits for renewable energy-related activities;
- A provision designed to promote insurance coverage for mental health and substance abuse problems that had previously passed the House by a substantial majority; and
- Disaster relief for victims of Hurricane Ike, and flooding and storms in the Midwest.

The major provisions of the economic stabilization legislation are discussed in more detail below.

Discussion

This discussion of the economic rescue plan is divided into four parts: first, the authorities and other directives given Treasury by the "economic stabilization" section of the legislation, including the authority to create and administer the TARP, are described; second, TARP oversight will be described; the obligations imposed on institutions participating in TARP will be discussed third; and finally, other stabilization provisions will be discussed.

1. Authority and Other Directives Given the Treasury Department

Division A of the legislation contains "economic stabilization" measures, which include the TARP provisions. Under TARP the Treasury Secretary is authorized to do the following:

- Purchase "troubled assets" that were initiated or originated on or before March 14, 2008. "Troubled assets" are defined as residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, the purchase of which the Secretary determines promotes financial market stability. Other types of financial instruments may also be

purchased under TARP if Treasury and the Federal Reserve Chair determine that such purchases are necessary and notify Congress of this determination;

- Make the purchases from "financial institutions," which includes but is not limited to banks, savings associations, credit unions, securities brokers or dealers, or insurance companies. The institutions must be established, regulated, and have significant operations in the U.S. Purchases of assets from foreign central banks or banks owned by foreign governments are prohibited;

- Make the purchases until December 31, 2009, with the ability to make a written request to Congress to extend the expiration to October 3, 2010 (that is, two years after the law's date of enactment);

- Acquire the troubled assets through direct purchases from an individual financial institution where no bidding process or market prices are available, or through the use of "market mechanisms" such as auctions or reverse auctions where possible. Treasury is directed to maximize the use of market mechanisms and "shall encourage" the private sector to buy troubled assets and invest in institutions with such assets;

- Where Treasury makes direct purchases from a financial institution, it must obtain non-voting stock warrants or senior debt instruments from the financial institution itself to help protect against losses from the sale of the troubled assets acquired from the institution. There is a de minimis exception to this requirement for transactions of less than $100 million. The Secretary is required to establish appropriate alternative requirements for institutions that are legally prohibited from issuing securities and debt instruments;

- If Treasury purchases troubled assets under TARP, it must also establish an insurance fund to guarantee "troubled assets" issued or originated before March 14, 2008, and establish risk-based premiums to be paid by institutions that desire to participate in the insurance program. The premiums must be sufficient to cover anticipated claims under the insurance program, and Treasury can make guarantees that will provide timely payment of principal and interest on the asset;

- Treasury is required to publish guidelines for how it will operate the program, including purchasing mechanisms, valuation methods, procedures for choosing third-party asset managers, and criteria for identifying troubled assets for purchase; guidelines must also be published explaining how Treasury arrives at the premiums it will charge for the insurance program;

- Treasury must take steps to prevent program participants from selling a troubled asset to the government for a higher price than what the seller paid to buy the asset. This provision does not apply to troubled assets acquired in a merger or acquisition, the purchase of assets in conservatorship or receivership, or the purchase from an entity that is in bankruptcy proceedings;

- Treasury can waive specific provisions of the federal government contracting regulations where "urgent and compelling circumstances" make compliance with those regulations contrary to the public interest, and is required to notify Congress of such waivers;

- Treasury must develop conflict of interest rules to address conflicts that may arise in administration of the TARP, including in the selection and hiring of contractors or advisors, including asset managers. Proponents of this particular requirement have explained that conflict of interest rules are necessary to address, for example, situations in which third-party asset managers hired to assist with the TARP also hold positions in troubled assets;

- For mortgages and mortgage-backed securities acquired through TARP, Treasury must implement a plan to mitigate foreclosures and to encourage servicers of mortgages to modify loans. Treasury may use loan guarantees and credit enhancement to avoid foreclosures. Treasury is also required to coordinate with other federal entities that hold troubled assets to identify opportunities to modify loans, considering the net present value to the taxpayer;

- A total of $700 billion is authorized for TARP, to be released in tranches as follows: initially only $250 billion can be outstanding at any one time; upon written notification by the President to Congress, authority can be increased to $350 billion outstanding; the remaining $350 billion will be authorized if the President sends

Congress a written, detailed plan for use of the remainder and Congress does not disapprove it within 15 days;

- A "recoupment" provision directs OMB and CBO to report to Congress in five years on whether TARP has made or lost money, and if there is a loss, the President is directed to submit a legislative proposal to recoup the shortfall from the "financial industry." Any profits from TARP must be used to pay down the national debt.

2. Oversight Provisions

- A Financial Stability Oversight Board will be created and will have oversight authority over Treasury. Board members will be the Treasury Secretary and the heads of the Federal Reserve, SEC, FHFA, and HUD;

- A Congressionally appointed oversight panel will also be created and will consist of two members appointed by the majority party, two by the minority party, and one member appointed by the majority party in consultation with the minority. This panel of outside experts is charged with studying "the current state of the financial markets and regulatory system" including Treasury's TARP activities and providing recommendations for improvements;

- Treasury must provide a number of detailed periodic reports to Congress, including financial statements for TARP transactions, and must report by April 30, 2009 on the current state of the financial markets, the effectiveness of the financial regulatory system, and recommendations for improvements;

- Treasury must publicly disclose the details of any transaction under TARP within two business days after the transaction;

- There will be GAO oversight and auditing of the program, and a special Inspector General for the program;

- Treasury's actions under the program will be subject to judicial review. However, there is a limitation on the availability of court injunctions to stop Treasury's actions with respect to the TARP, insurance program, and foreclosure mitigation efforts. Such injunctions can only be granted to address constitutional violations and courts are directed to handle any such matters on a highly

expedited basis. TARP participants may only sue Treasury for violations of the Administrative Procedure Act.

3. Obligations Imposed on Financial Institutions Participating in TARP

- Executive compensation limits will be imposed on institutions that participate in the program. The limits differ depending on whether Treasury acquires the assets directly from the institution (and takes the required equity or debt stake in the institution) or whether they are acquired through auction:

    - Where the Secretary acquires assets directly, the compensation limits must include: 1) limits on incentives that encourage management to take inappropriate or excessive risk; 2) claw back of bonus compensation that is based on statements of earnings, gains or other criteria that later prove to be false; and 3) no golden parachutes for senior executives;

    - For assets purchased by Treasury through an auction from institutions that have sold more than $300 million in troubled assets to Treasury, the compensation limits are relaxed somewhat – the institutions are (1) subject to a 20% excise tax on golden parachutes triggered by events other than retirements; (2) prospectively prohibited from agreeing to golden parachutes for the top five executives in the case of involuntary termination, insolvency or receivership of the institution; and (3) tax deductions for executive compensation are limited to $500,000 (with compensation defined to include bonuses and stock options);

- The compensation limits become effective upon an institution's entry into the TARP and last as long as Treasury has an equity or debt position in the institution in the case of direct asset purchases, or until TARP sunsets in the case of other types of purchases;

- Companies that sell troubled assets directly to Treasury must give Treasury non-voting stock warrants or senior debt instruments to help protect against losses from the sale of the troubled assets Treasury acquires from the institution. There is a de minimis exception to this requirement for transactions of less than $100

million. The Secretary is required to establish appropriate alternative requirements for institutions that are legally prohibited from issuing securities and debt instruments.

- The institutions that are required to give Treasury an equity or debt position are prohibited from taking actions that would impair or dilute the value of Treasury's interest in the institution.

4. Other Stabilization Provisions

- Treasury is required to reimburse the Economic Stabilization Fund for any money taken from that fund to provide guarantees for money market mutual funds; Treasury is prohibited from using the Economic Stabilization Fund to create any money market mutual fund insurance program in the future;

- The SEC is authorized to suspend FASB Statement 157, of which the mark-to-market accounting rules are a part, for any issuer or category of transaction if the SEC determines that suspension is required by the public interest. The SEC and FASB are directed to study mark-to-market accounting standards including their effect on balance sheets, any role the rules played in bank failures in 2008, their impact on the quality of information received by investors, and recommendations for alternatives. A report must be provided to Congress on this issue 90 days from enactment of the bill;

- The limit on FDIC insurance is increased from $100,000 to $250,000. The increase only lasts until December 31, 2009. The new maximum is not to be taken into account in setting assessments for FDIC insurance. The FDIC is permitted to borrow from Treasury to cover the costs of the new insurance limit. Corresponding changes are made to the insurance program that covers credit union accounts;

- A change to the tax code permits any losses on sales of Fannie Mae and Freddie Mac preferred stock by financial institutions or financial institution holding companies to be treated as ordinary losses. This applies to any preferred stock that was owned on September 6, 2008 or sold between January 1 and Sept 6, 2008. The purpose of this provision reportedly is to allow banks to obtain the tax benefit of the loss on the preferred stock and therefore reduce the need to obtain additional capital; and

- The bill extends for three additional years the tax code provision that allows taxpayers to exclude mortgage debt forgiveness from their taxable income.

Conclusion

This new law will present a host of complex and novel challenges not only for entities desiring to participate in TARP, but for those wishing to influence the implementation process, those interested in the future direction of financial regulation, and the many entities that need to understand how this legislation affects their interests.

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Steptoe's new Troubled Asset Task Force is ready to advise financial institutions, sellers and purchasers of assets, asset managers, and program managers on the economic stabilization legislation passed this week by the U.S. Congress. Focused on helping businesses at every scale nationwide navigate wisely in the wake of the current tumult in capital markets, the Task Force is structured to advise clients in the post bailout economy and the new regulatory landscape. This multi-disciplinary group will provide coordinated representation in matters involving Congressional oversight investigations; white collar criminal defense; federal contracting opportunities; tax law, ERISA and executive compensation; and, mortgage and asset securitization and structured financing. Steptoe's restructuring and distressed asset attorneys are also aboard to formulate complex and innovative approaches to workouts and troubled real estate transactions, and counsel clients on the judicious sale and acquisition strategies and liquidation of distressed assets. The Troubled Asset Task Force is well aligned with and supports the firm's national Subprime & Credit Crisis Team, organized last year in response to early concerns within the residential lending market.

Leadership of the Task Force is provided by Washington, D.C.-based partners Scott A. Sinder, chair of Steptoe's Government Affairs & Public Policy practice and General Counsel to the Commercial Mortgage Securities Association; John T. Collins, a member of the firm's Corporate, Securities and Finance practice and its Regulatory & Industry Affairs Department, who was formerly General Counsel to the US Senate Banking Committee, a Senior Attorney at the Washington D.C. Federal Reserve Board and a Staff Attorney with the SEC; and Scott H. Katzman, head of Steptoe's Corporate, Securities and Finance practice.

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