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Treasury Issues Broad Based Financial Stability Plan for TARP Reform

Introduction

After weeks of speculation, on February 10, 2009, Treasury Secretary Geithner introduced the government's latest plan to stabilize the financial system painting a broad picture with few specifics. Secretary Geithner's strategy is to fight the battle for economic recovery on two fronts by (i) jumpstarting job creation and private investments and (ii) getting credit flowing again to businesses and families.

Before outlining the key elements of his plan, Secretary Geithner explained how the financial crisis evolved into the current situation. He stated that governments and central banks pursued policies that produced a credit boom, which inflated housing prices and financial instrument values. Further, investors and banks took uneducated lending and investing risks; individuals, governments and businesses borrowed beyond their ability to repay; and financial executives received rewards in excess of the appreciated risks. Secretary Geithner also blamed systemic failures of the checks and balances in the system, including government regulatory agencies, credit-rating agencies and boards of directors of financial institutions.

Secretary Geithner continued by explaining that once the crisis was identified, governments of the world reacted too slowly and inadequately. Such a late and inadequate response only deepened investor uncertainty and the public's anxiety. The failure of the world's largest financial institutions and the unclear criteria and conditions applied to the "bail-out" of those failing institutions led to a pull out by investors.

Secretary Geithner averred that while Congress acted quickly and courageously in the fall of 2008, the response was inadequate in light of the "deepening pressure of the weakening economy." Furthermore, taxpayer confidence in their government was shaken by the "spectacle" of taxpayer money being provided to the very institutions that caused the financial meltdown, with little or no oversight, while senior executives of those institutions were exorbitantly compensated.

Secretary Geithner provided further guidance as to the particulars of the Treasury's financial stability plan.

Financial Stability Trust

The Financial Stability Trust ("FST") is the structure proposed through which efforts will be made to strengthen financial institutions so they can support an economic recovery. While there is no reference to the British model, it appears there are some similarities to the United Kingdom Financial Investment ("UKFI"). Like the UKFI, the FST is a special purpose vehicle created to manage the government's investments in financial institutions. However, the UKFI, unlike the FST, typically does not hold investments in nationalized companies such as the Royal Mail and Nuclear Power Companies. Those nationalized companies are held by the Shareholder Executive ("SE"). Questions arise whether this SPV will provide an accounting advantage in that it will permit the government to hold Capital Assistance Program ("CAP") investments "off budget."

Financial institutions applying in the second round of the Troubled Asset Relief Program ("TARP") will be subjected to a forward-looking assessment or financial "stress test" to determine if those banks have the needed capital to weather this financial storm. To accomplish this, the Federal Reserve, FDIC, OCC and OTS, working together will scour the balance sheets of those institutions for potential risks. Secretary Geithner's plan calls for increased transparency and public disclosure to aid banking regulators in their endeavors to assess these risks. The Treasury release refers to "measures to improve the disclosure of the exposures on bank balance sheets" to the disappointment of those who were expecting some relief on fair value accounting. Notably, while performing their financial check-ups on financial institutions, government regulators are cautioned not to take an overly conservative posture or take steps that would restrict lending - a delicate balancing measure. Initially, the stress test will apply to those institutions having more than \$100 billion in assets, a current roll call that consists of 13 banks.

Once a bank has undergone a comprehensive “stress test,” should that financial institution need additional capital, the CAP would provide Treasury funds to be used as a capital buffer. Presumably, if the institution fails the test under a mild downturn scenario, it would not qualify and would only be a candidate for exceptional assistance. It is not clear whether investments in banks receiving exceptional assistance will be commingled in the FST or held separately in a SE type entity. The capital buffer would provide a bridge to private capital and help the bank absorb losses. Banks will receive a preferred security investment in convertible securities that can be converted into common equity to preserve lending should the economy continue its downward slide. These convertible preferred securities will be priced at a modest discount from such financial institution’s stock price as of February 9, 2009 and will carry a to-be-determined dividend. With a capital buffer to serve as “contingent equity,” the Treasury expects that the banks can begin to lend again and restart the lending markets. However, Treasury funds serving as a capital buffer would come with significant strings attached, which have yet to be revealed.

Public-Private Investment Fund for Toxic Assets

As proposed, the Treasury Department would provide an initial \$500 billion in government capital and government financing in the shape of a Public-Private Investment Fund, with the prospect of expansion to \$1 trillion in the future. The goal of the fund would be to clear the “legacy” toxic assets (e.g. bad loans and securities) off the banks’ balance sheets. This, in turn, would free up the flow of credit in the economy.

Secretary Geithner explained that the structure of this program was still in flux with many options being discussed. One potential pitfall is the valuation of the toxic assets, as banks are holding the assets at par while investors would only buy those assets at current market value.

Secretary Geithner’s plan intends to marry private sector equity contributions with government funds in the large-scale purchase assets, which would permit private sector buyers to set the prices on the troubled assets.

The lack of clarity as to how this fund would operate has caused investors to conclude that it is not the “bad bank” plan they were expecting. Recently, the talk in Washington, D.C. had moved to confident expectation that Secretary Geithner’s plan would include the euphemistic “aggregator bank.” The proposal seems to resist this approach because of its “sole reliance on public purchasing and the difficulties in pricing assets.”

The Consumer and Business Lending Initiative

A third element of Secretary Geithner’s proposal calls for a \$1 trillion support of a consumer and business lending initiative. Treasury, in a joint effort with the Federal Reserve, will provide \$100 billion in initial funds to expand the Federal Reserve Term Asset-Backed Securities Loan Facility (“TALF”). This initiative provides government financing for the purchase of loans backed by credit cards, student loans and the like. The proposal expands the categories of assets to include commercial mortgage-backed securities. A consequence of this initiative would be the unfreezing of consumer and business credit and lower interest rates. Notably, Treasury’s purchases are limited to new and AAA-rated. This initiative also expands the reach of TALF to cover CMBS, with potential further TALF expansion options to include other asset classes. There is hope for those seeking to trade in lower rated or other classes of assets as Treasury acknowledges it will continue to consult with the Federal Reserve Board regarding expansion of the TALF program.

Transparency, Accountability, Monitoring and Conditions

Secretary Geithner’s plan pays special attention to the public’s overall dissatisfaction with the government’s previous attempt at a financial stability plan, which includes the TARP. Accordingly, Secretary Geithner called for “greater transparency, accountability, and conditionality with tougher standards” for those institutions receiving “exceptional” assistance. *Notably, these tougher standards will not be applied retroactively to those firms that previously received TARP assistance.*

Firms receiving exceptional assistance (previous examples include AIG and Citigroup) or CAP funds will have to demonstrate how receipt of Financial Stability Plan funds will expand lending. Those firms will be required to track every dollar and demonstrate how such funds enabled them to preserve or generate new lending compared to what would have been possible absent government assistance. When applying for receipt of CAP funds, the firms must submit a plan on how the funds will be used. After receipt of such funds, the firms will submit monthly reports to Treasury detailing the use of the funds and the impact on lending. Those monthly reports will be made available to the public at FinancialStability.gov.

To improve bank capital and further promote lending, Secretary Geithner’s plan proposes to limit common dividends, stock repurchases and acquisitions. Banks receiving exceptional assistance can provide for a dividend but only at \$0.01 per share, per quarter. Further, banks receiving CAP funds are prohibited from repurchasing privately-held shares until all CAP funds are repaid. Finally, cash acquisitions of healthy firms by CAP-assisted banks are restricted, subject to limited exceptions. Mergers not involving cash payouts are excepted, which will increase the number of mergers using some form of a security for payment. Presumably debt junior to Treasury-held securities would qualify.

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Other requirements to promote transparency and accountability include the applicability of the recently announced executive compensation restrictions to all firms receiving government assistance, measures to curtail lobbyists' influence in investment decisions and posting of all contracts on FinancialStability.gov within five to 10 business days of their completion.

forming but illiquid assets. The principal question remaining is whether Treasury will adopt a measure for resolving the toxic assets on the books of so many banks and restart the markets for other classes of assets for which there is no buyer. Clearly, this latest proposal gives Treasury the flexibility to do so once it exhausts other avenues.

Comprehensive Housing Program

Secretary Geithner's plan provides \$50 billion to enact measures designed to stop the spiraling foreclosure crisis. By purchasing GSE mortgage-backed securities and GSE debt, Treasury and the Federal Reserve intend to drive down mortgage interest rates. The initial \$50 billion infusion will help reduce mortgage payments on owner-occupied mortgage loans to stave off avoidable foreclosures. Treasury will establish additional guidelines based on industry standard best practices to assist financial institutions in loan modification transactions with existing borrowers. Also, banks receiving federal aid will be required to participate in foreclosure mitigation plans consistent with those guidelines. However, the details of this proposal remain in flux with the President expected to outline the complete details of the plan in the following weeks.

Small Business and Community Lending Initiatives

Secretary Geithner's plan, while short on details, also provides for increased lending to communities and small businesses. By increasing the government's guaranteed portion on SBA loans, the program will permit banks to introduce measures to streamline borrowing for small businesses, including a reduction in loan fees and speedier loan application processing.

Conclusion

While there was a high expectation for a plan that would spell out in detail Treasury's solution to the banking crisis, Treasury Secretary Geithner chose to keep his options open. The plan announced yesterday is very much a work in progress. The markets were disappointed in that they expected a neatly wrapped package that would include an aggregator bank, mark-to-market reform and massive guarantees of per-

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