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Take Two: Treasury Announces the Financial Stability Plan

On February 10, 2009, Treasury Secretary Geithner released an outline of his Financial Stability Plan, a six-pronged approach to "help restart the flow of credit, clean up and strengthen our banks, and provide critical aid for homeowners and for small businesses" with "new, higher standards for transparency and accountability." Secretary Geithner's only mention of the much maligned TARP was a passing reference to the "current program" being replaced.

The Financial Stability Plan is intended to be executed in a cohesive fashion by the U.S. Treasury Department (Treasury), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (Federal Reserve) and other government agencies. To enhance transparency, all aspects of the plan are to be disclosed through a new website at www.financialstability.gov.

Please see our coverage of the current financial crisis, including actions and programs of Treasury, the FDIC and the Federal Reserve at Financial Crisis Legal Updates and News.

Overview

The Financial Stability Plan, or Plan, includes the following components, which we discuss in more detail below:

1. The *Financial Stability Trust* will be established to hold investments in banking institutions made to strengthen those institutions and encourage lending.

2. The *Public-Private Investment Fund* will be established to acquire assets from the balance sheets of financial institutions through a private equity and government investment partnership. The initial program size is targeted at $500 billion, and the structure of the program will be developed in the coming weeks based on input from market participants.

3. A *Consumer and Business Lending Initiative* will be launched, leveraging the Term Asset Backed Securities Loan Facility (TALF) and expanding the size and scope of the TALF. For more information on the TALF, please see our Client Alert at http://www.mofo.com/news/updates/files/090210TALF.pdf.

4. The *Transparency and Accountability Agenda*, including enhanced participant accountability requirements and increased disclosure, will be a guiding principle of the Plan.

5. An *Affordable Housing Support and Foreclosure Prevention Plan* will be announced in the coming weeks to help bring down mortgage rates and reduce mortgage payments for eligible borrowers, in order to end the downward spiral of new foreclosures that drive down housing values.

6. A *Small Business and Community Lending Initiative* will increase the federally guaranteed portion of Small Business Administration (SBA) loans and establish expedited loan approval procedures.

The Plan outline provides a high-level overview of each of these elements. Details, such as the structure of the new trust and fund, the sources of funds and in many cases size of each program, and the timetable for launch or implementation are not currently available.

Financial Stability Trust

Federal banking regulators will perform "stress tests" on the balance sheets of financial institutions with assets in excess of $100 billion to assess each institution's ability to absorb losses and continue lending. The review process will be coordinated by all financial regulators, including the Federal Reserve, Office of the Comptroller of the Currency, the FDIC and the Office of Thrift Supervision (OTS). Additionally, Treasury will work with the Securities and Exchange Commission to improve public disclosures by financial institutions.

Institutions in need of additional capital will be encouraged to seek private funds, but will be able to access a Treasury "capital buffer" to act as a bridge to private investment through a "CAP" program. The bridge would be in the form of a preferred equity security convertible, should the entity need long-term capital, into common equity. All CAP securities would be held by a separate entity, the Financial Stability Trust. Entities not participating in the stress test program that nevertheless identify a need for additional capital would be eligible to apply for CAP bridge financing.

The source of funds for this program was not provided in the announcement, but Treasury has previously announced an intention to expand the Capital Purchase Program established under the $700 billion authority of the Emergency Economic Stabilization Act (Stabilization Act). The new program raises many of the same questions identified when the Capital Purchase Program was first announced. For example, although described as a convertible preferred security, we expect Treasury would implement versions of the program for the various capital structures of financial institutions.

Public-Private Investment Fund

The Plan would establish a Public-Private Investment Fund, or Fund, to remove "legacy" assets (formerly known as "troubled assets" or "toxic assets") from the balance sheets of financial institutions. The terms and structure of the Fund are to be developed with input from market participants. Initial government investment is targeted at $500 billion, with an ultimate investment of up to $1 trillion. Treasury, the FDIC and the Federal Reserve are committed to participate in the Fund.

It has been widely reported that the development of a plan to purchase legacy assets has been hampered primarily by the challenges in implementing a pricing mechanism. According to the Plan Fact Sheet, the Fund would have private investors partner with government investors, and the private investors would price, presumably through a bidding process, the assets to be purchased. No additional details have been provided regarding the program.

A number of non-financial institutions have reportedly expressed an interest in the resources available from the Stabilization Act. There is no indication, however, that the Fund would be authorized to purchase assets from a broader group of institutions than those financial institutions participating in government programs to date.

Although described as an "investment fund," the proposal provides that individual private entities would determine prices for specific purchases of assets. It isn't clear whether private investors would pool resources into a fund, or whether the government resources will constitute the investment fund. Given the limited disclosure regarding the independent pricing by individual private investors, the latter may be more likely.

Consumer and Business Lending Initiative

One of the impacts of the financial crisis has been a dramatic constriction of lending. In his remarks, Secretary Geithner notes that 40 percent of consumer lending has been funded through the securitization markets, and between 2006 and 2008 there was a $1.2 trillion decline in securitized lending (excluding government sponsored enterprise (GSE) securitization). Unavailability of the securitization markets has dramatically impacted available funding for consumers as well as businesses. The TALF program announced in November and scheduled to be launched this month is designed to restart the securitization markets by providing non-recourse loans to purchasers of asset-backed securities secured with consumer and small business loans.

Under the Plan, the TALF program will be increased from $200 billion to up to $1 trillion. Additionally, the group of lenders able to benefit from the program will be expanded to include commercial real estate lenders, in addition to those included originally, lenders making auto loans and leases, credit card loans, student loans and small business loans. For more information on the TALF, please see our Client Alert "TALF to Launch with Updated Terms: Can Wall Street Help Main Street?" at http://www.mofo.com/news/updates/files/090210TALF.pdf.

Transparency and Accountability Agenda

Responding to criticism from Congress, the media and others, Treasury announced a "new era of transparency, accountability, monitoring and conditions." The policies set forth in the Plan will be prospective and not retroactive and were influenced by the work and reports of the Congressional Oversight Panel, Special Inspector General, General Accountability Office and Congressional committees.

Specific components of the new agenda will include the following:

- Recipients of government crisis funds will document and disclose how each dollar received enables them to preserve or generate new lending compared to their abilities prior to government intervention, through:
  - Submission of a plan during the application process for how the funds will be used and public disclosure of the plan upon closing of the related transaction; and
  - Monthly reports submitted to Treasury (1) detailing lending activities, investment activities and providing descriptive disclosure of lending markets, (2) comparing current activities to what lending would have been absent government funds and (3) for public companies, filing the monthly reports with the SEC.
- Treasury, in collaboration with banking agencies, will publish monthly reports on the impact of the Plan on the financial markets using consistent key metrics to measure success.
- Extensive use of www.financialstability.gov to provide public disclosure, including posting of all final contracts, including the value of investments, within ten days of completion.
- Recipients of capital investments will agree to participate in mortgage foreclosure mitigation programs using best practices guidelines to be released by Treasury.
- Recipients of government crisis funds will agree, unless consent is received from Treasury and the primary federal banking regulator, and until the government investment has been repaid:
  - to limit quarterly dividends to $0.01;
  - to refrain from repurchasing privately-held shares; and
  - to refrain from acquiring healthy firms (with exceptions available for supervisor-approved restructuring plans).

- Compliance by recipients with the executive compensation requirements for financial institutions receiving exceptional financial recovery assistance announced on February 4, 2009.[1]
- Treasury certification that lobbyists do not influence investment decisions.

If this agenda for transparency had been implemented with the Capital Purchase Program, Treasury may have been spared much of the criticism of the past several months. However, it is unlikely that the hundreds of financial institutions applying for the capital would have done so if faced with these reporting and disclosure requirements. As initially announced, the Capital Purchase Program was designed for "healthy" financial institutions, in an effort to restore confidence in the banking sector. The new capital bridge program, on the other hand, will be for those institutions that need assistance while seeking required additional capital after a regulatory stress test has highlighted balance sheet weakness. Perhaps the more accurate articulation of the dissatisfaction with the TARP would be a lack of faith in Treasury's initial concept—that healthy banks needed taxpayer support—and a lack of faith in Treasury's ability to distinguish healthy banks from less healthy banks. One potential outcome of the agenda is that financial institutions that need additional capital will consider all possible alternatives to government intervention, including reduction of balance sheets and lending activities.

Affordable Housing Support and Foreclosure Prevention Plan

Treasury's foreclosure plan is expected to leverage the FDIC's foreclosure plan,[2] developed after IndyMac Federal Bank went into receivership in 2008. The comprehensive plan, to be released soon, will include:

- Continued efforts by Treasury and the Federal Reserve to reduce mortgage interest rates through previously announced plans to purchase GSE mortgage-backed securities and GSE debt.
- Commitment of $50 billion to prevent avoidable foreclosures by reducing monthly payments. This represents the commitment of the Administration, in connection with the request to release the final funds under the Stabilization Act, to allocate at least $50 billion to mortgage modification and foreclosure prevention efforts.
- Establishment of mortgage modification guidelines and standards for use across government and private programs.
- Requiring Plan recipients to use Treasury guidance for mortgage modifications.
- Building flexibility into Hope for Homeowners and the Federal Housing Administration to increase modifications.

Small Business and Community Lending Initiative

The Plan outline notes that SBA lending in the fourth quarter of 2008 was down 57 percent from the fourth quarter of 2007 for 7(a) loans.[3] To address the constriction of small business lending the Plan will include the following:

- A plan to purchase AAA-rated SBA loans to unfreeze the secondary funding market for these loans;
- Inclusion, within the American Recovery and Reinvestment Act, of authorization to increase the SBA guarantee of loans from 75% to 90%; and

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[1] For more details on the executive compensation requirements for financial institutions receiving exceptional financial recovery assistance, please see our Client Alert "Treasury Ties Bailout Funds to Limits on Executive Pay" available at http://www.mofo.com/news/updates/files/090205ExecutivePay.pdf.

[2] The FDIC's Loan Modification Program is available at http://www.fdic.gov/consumers/loans/loanmod/FDICLoanMod.pdf.

[3] Section 7(a) of the Small Business Act authorizes the SBA to guarantee small business loans made by bank and non-bank lenders to small businesses; these are the most used SBA loans.

- Reduction of fees for two SBA loan programs, increased SBA funding for oversight and less burdensome loan review processes.

Conclusion

As noted by Secretary Geithner, “this strategy will cost money, involve risk, and take time.” There is no aggregate dollar value assigned to the Plan, but the scope of the proposals and the language of the announcement make clear that additional funding from Congress is likely. Although many expected a more detailed announcement, providing a multi-faceted and longer-term approach to address the current financial crisis, including the many of its root causes, this is an essential first step in framing the issues and setting the stage for complex programs involving multiple agencies. In that regard, Secretary Geithner made his presentation alongside Federal Reserve Chairman Ben Bernanke, FDIC Chair Sheila Bair, John Dugan, the Comptroller of the Currency and John Reich the head of the OTS. He also committed to doing “everything in his power to ensure that [all government bodies] act as one.”

In addition to pushing for cohesive action by various governmental constituents, Secretary Geithner also offered a preface to the upcoming discussion of regulatory reform. In anticipation of the G-20 summit on April 2nd, he indicated significant work would be done to prepare for broader regulatory reforms.

We can expect, once again, a flurry of announcements of program descriptions (with new names and on a new website), proposed regulations and legislation, interpretations and policy guidance, requests for input, proposals and comments and, in the midst of developing the Plan, the initial thoughts on regulatory reform.

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