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Financial Stability Plan

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Today, Treasury Secretary Timothy Geithner unveiled the Obama Administration's Financial Stability Plan for the support and rejuvenation of the nation's financial system. While much remains to be learned about the details of this plan – and some aspects are not fully structured yet, according to Mr. Geithner's own remarks – the contours of the new program are becoming clearer.

I. New Programs

Mr. Geithner identified three new programs that the Treasury Department will be implementing:

A. Capital Support

The first new program will be for capital support to banks – a kind of "Son of TARP." The investment will be made through a separate trust, called the Financial Stability Trust. The elements of this program will include:

- Stress Test – The availability of capital from the Treasury Department will be premised on applying a stress test to the financial condition of the bank. The various supervisory agencies will utilize more consistent and realistic assumptions in analyzing the survival prospects for each bank. The stress test will be mandatory for (1) banks with assets over $100 billion and (2) smaller banks that seek Treasury funds for use to fill the capital "gap" by absorbing losses, and to support acquisition of increased private capital.
- New Funding Mechanism – The new funding will be in the form of preferred stock that can convert into common stock if the economy worsens. The conversion price will be slightly below the bank's stock price on February 9, 2009. The dividends on the preferred

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shares will be set later and may be different from the 5% dividend rate that was uniformly used in TARP.

- Lending – The capital will be made available where the bank will engage in lending "greater than what would have been possible without government support."

It is significant that the Treasury Department is not saying that every dollar of capital support needs to be loaned out by the banks. Clearly, the Treasury Department recognizes that a bank cannot lend if to do so would cause its capital to be inadequate. Thus, the use of government funds to fill a capital "gap" is recognized as an acceptable use. However, the government will not invest if its funds are merely sufficient to fill that gap, without also providing a platform for additional capitalization that will support loan origination. With this formulation, the Treasury Department seems to be signaling a willingness to engage in what might be termed open bank assistance, where a bank is able to leverage the government's capital investment with new private capital and borrowing (through deposit growth or borrowings), to facilitate much more substantial lending capacity.

B. Portfolio Assets

The second initiative that Mr. Geithner announced is a Public-Private Investment Fund that will be targeted primarily to legacy portfolios of loans and other assets. He stated that the Treasury Department is still exploring a range of different structures for this. We imagine that these structures are the single "aggregator bank," possibly with separate sub-funds, and the use of multiple "bad banks." Both of these concepts have been discussed in recent weeks in the press. Possibly more than one would be used.

The massive issue of pricing continues to plague this subject. Mr. Geithner provided some insight into how that issue will be addressed, when he focused on the role of the private sector in the new Investment Fund. He is counting on the private-sector partners to bring rationality to the pricing.

This program will use public financing to leverage private capital on an initial scale of up to $500 billion. If the program works, and with such tweaks as the initial efforts may prompt, it could be doubled at a later time.

Unfortunately, nothing in the proposed plan covers the essential question for banks of whether they will be protected if they sell an asset at a market price that is less than the asset's book value (net of specific reserves). This issue will need to be addressed in order to encourage banks to begin disposing of troubled assets from their balance sheets. The use of the public-private approach seems designed to allow the private sector to go about the business of maneuvering towards a price, and implicit in that approach is an expectation that those banks that do not either write down or reserve for an adequate pricing adjustment are going to be unable to sell into this facility.

C. New Lending through Securitization

The third initiative will be to restart lending and securitization. This initiative is referred to as the Consumer & Business Lending Initiative and will use $100 billion in public capital to leverage up to $1 trillion and trigger lending by focusing on new loans. This program will be built upon the Term Asset-Backed Securities Loan Facility (TALF) that has been announced but not yet implemented under the auspices of the Federal Reserve Board. It will be administered by the Federal Reserve Board, with capital from the Treasury Department. This will be used to purchase senior securities, with AAA ratings, that are issued by securitization trusts composed of various types of consumer and business loans.

In announcing this element of the program, Mr. Geithner expressed support for securitization as a crucial element for bringing funds to the consumer and small business sectors of the economy.

Significantly, Mr. Geithner included small business loans and commercial mortgage loans, along with student, auto, and credit card debt, among the types of lending that would be supported through this program. The Treasury Department and the Federal Reserve will also consider possible expansion of this program in the future to securitizations of residential mortgage loans and of corporate debt.

II. Oversight and Governance

Mr. Geithner described a new framework for oversight and governance. Evidently, this is intended to apply both to banks that have received funding under the previous TARP, and those that participate in the coming new programs. Mr. Geithner emphasized transparency, and said that the information gathered in the course of the government's oversight will be published on a new Web site, www.FinancialStability.gov.

Coincidentally, the Treasury Department's Office of the Special Inspector General for the Troubled Asset Relief

Program has begun sending letters to banks that were recipients of TARP funding in the past, asking a series of questions about what they intended as the use of the TARP money when they were making their applications, and how the money was actually used. The disclosures requested in these letters are in many ways similar to the commitments that will be required of future recipients of capital support, under the Treasury Department's new programs.

Recipients of capital under the new initiatives will also be subject to standards on the following subjects:

- Foreclosure mitigation on terms to be released in the future by the Treasury Department.
- Executive compensation under the rules that were announced last week, which include a $500,000 cap in total compensation, nonbinding shareholder votes, and new disclosure and accountability requirements applicable to luxury purchases.
- Dividend limitations to $0.01 per quarter (mandatory for recipients of "exceptional" assistance, waivable for others).
- Share repurchase prohibition unless approved by the Treasury Department and the bank's primary regulator.
- Cash acquisition prohibition as to healthy firms (waivable for supervisory restructurings).
- Lobbying prohibition requiring the Treasury Department to certify that each investment decision was based only on investment criteria and the facts of each case.
- Disclosure publicly of all contracts under the Financial Stability Plan on FinancialStability.gov within 5 to 10 business days of their completion.

III. Other Concurrent Efforts

Without getting into much detail, Mr. Geithner's remarks also identified these efforts that the Treasury Department is starting:

- SBA Loans – Increased funding for loans guaranteed by the Small Business Administration (SBA) through a purchase of securitized loans under the Consumer & Business Lending Initiative described above, increasing the guarantee for SBA loans to up to 90%, reducing fees for SBA 7(a) and 504 lending, and providing funds for both oversight and more expeditious processing of SBA loan applications.
- Housing – A comprehensive housing program, using funds already authorized by Congress, to assist homeowners.
- Regulation – Changing the system of regulation of the

financial industry.

- International – Working with his counterparts in other countries to stabilize the global financial system.

For additional information on this issue, contact:

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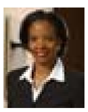

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