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Treasury's Asset Guarantee Program

When the Emergency Economic Stabilization Act (Act)[1] was passed in October 2008, it required the U.S. Department of the Treasury (Treasury) to develop a program to "guarantee the timely payment of principal of, and interest on, troubled assets in amounts not to exceed 100 percent of such payments." On December 31, 2008, Treasury announced the establishment of an Asset Guarantee Program (Program). Treasury's objective for the Program is "to foster financial market stability and thereby to strengthen the economy and protect American jobs, savings, and retirement security."[2]

For more information on the Act and the other financial crisis related government actions to date, please see our related publications available at Financial Crisis Legal Updates and News.

Background

As originally presented to Congress, former Treasury Secretary Paulson's bailout proposal did not include a guarantee program. Members of Congress, concerned that the proposal would result in significant U.S. government ownership of troubled assets, pushed for inclusion of an alternative insurance, or guarantee, program. Although a program to guarantee assets reduces the initial expenditure of taxpayer money and retains private ownership of troubled assets, Treasury has found it challenging to implement the program. In addition, a guarantee, while protecting a financial institution against future losses, does not provide the institution with new capital or liquidity.

Under the Act, each guarantee reduces the amount available under the Act on a dollar for dollar basis, offset only by the amount of any cash premium collected. For example, a guarantee on an asset valued at $10 million would reduce the amount available to Treasury under the Act by $10 million, offset only by the amount of any cash premium collected. As a result, the benefits of the guarantees, balanced by the burden of determining a premium, must be weighed against the benefits of the Act's alternative programs.

A guarantee program requires detailed negotiation by the parties to each transaction. Treasury and a participant must agree on the valuation of the assets, including whether Treasury will guarantee the full face value, the current marked-down value, or losses within negotiated thresholds. In addition, both parties must agree on the asset pool size and composition, the term and coverage of the guarantee, and associated premiums. As a result of illiquid markets for troubled assets, the assets have been marked down to different values on financial institutions' balance sheets. Each financial institution holds a unique quantity and composition of troubled assets and each institution is willing, or able, to absorb different losses and pricing premiums. The terms of a guarantee must be

[1] The December 31, 2008 report to Congress is available at http://www.treas.gov/press/releases/reports/0010208%20sect%20102.pdf.
[2] The objective is the same for both the Targeted Investment Program, available at http://www.treas.gov/initiatives/eesa/program-descriptions/tip.shtml, and the Asset Guarantee Program, available at http://www.treas.gov/press/releases/reports/0010208%20sect%20102.pdf.

negotiated separately with each institution; standardized objective terms cannot be established for an auction process or other broad-based guarantee program.[3]

The calculation of the premium affects the desirability of the guarantee. Sections 102(c)(2) and 102(c)(3) of the Act provide that premiums must be set based on the risk of the troubled asset and to "create reserves sufficient to meet anticipated claims, based on an actuarial analysis, and to ensure that taxpayers are fully protected." A detailed underwriting function is necessary to evaluate the risks and determine the amount of the premium. Given that a high percentage of troubled assets are illiquid, distressed, high risk and in many cases, non-performing, premiums should be high in order for the guarantee program to meet the statutory guidelines.

Faced with these challenges, on October 10, 2008, Treasury requested public input on the guarantee program, "seeking the best ideas on structuring options for the insurance program."[4] Responses were due by October 28, 2008[5] and ten weeks later, on December 31, 2008, Treasury issued its report to Congress, establishing the Program under Section 102 of the Act.[6]

Asset Guarantee Program Terms

As announced on December 31, 2008, the Program will provide guarantees on troubled assets held by "systemically significant financial institutions that face a high risk of losing market confidence due in large part to a portfolio of distressed or illiquid assets." This is one of the factors used to evaluate whether an institution qualifies for Treasury's Targeted Investment Program, the program used for the follow-up Treasury investments in Citigroup and Bank of America.[7] In the report, Treasury noted that the Program will not be made widely available, and potential participants will be evaluated using the same five factors established for the Targeted Investment Program.

The five factors for the Targeted Investment Program are:

1. The extent to which destabilization of the institution could threaten the viability of creditors and counterparties exposed to the institution, whether directly or indirectly;

2. The extent to which an institution is at risk of a loss of confidence and the degree to which that stress is caused by a distressed or illiquid portfolio of assets;

3. The number and size of financial institutions that are similarly situated, or that would be likely to be affected by destabilization of the institution being considered for the program;

4. Whether the institution is sufficiently important to the nation's financial and economic system that a loss of confidence in the firm's financial position could potentially cause major disruptions to credit markets or payments and settlement systems, destabilize asset prices, significantly increase uncertainty, or lead to similar losses of confidence or financial market stability that could materially weaken overall economic performance; and

5. The extent to which the institution has access to alternative sources of capital and liquidity, whether from the private sector or from other sources of government funds.

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[3] Treasury faced similar challenges with an asset purchase program. Assigning values to illiquid and distressed assets requires one-on-one negotiation with counterparties. Additionally, negotiating prices or premiums based on diverse pools of assets is time intensive.
[4] Treasury's request for comment is available at http://www.treas.gov/press/releases/reports/federalregisternotice1.pdf.
[5] Responses to Treasury's request are available at http://www.regulations.gov/search/search_results.jsp?sid=11F5D6AB1377&Ntt=asset+guarantee&Ntk=All&Ntx=mode+matchall&N=8060&css=0&Ne=2+8+11+8053+8054+8098+8074+8066+8084+8055+11.
[6] The December 31, 2008 Treasury report is available at http://www.treas.gov/press/releases/reports/0010208%20sect%20102.pdf.
[7] A description of the Targeted Investment Program is available at http://www.treas.gov/initiatives/eesa/program-descriptions/tip.shtml.

To be eligible for the Program, a troubled asset must have been originated prior to March 14, 2008. Treasury will provide protection against specified losses on each guaranteed asset, determined on a case-by-case basis. Such protection may be structured similar to that provided in the Citigroup or Bank of America transactions (described below), with one party, the entity holding the asset, assuming the first loss position, and Treasury assuming a secondary loss position. Additionally, the institution will be subject to portfolio management guidelines for the covered assets, to be established by Treasury.

The December 31, 2008 report on the Program notes the unique guarantee accounting mandated by the Act and outlines Treasury's considerations when evaluating a guarantee structure. The guaranteed portion of the troubled asset reduces, on a dollar for dollar basis, the funds available for use under the Act, offset by the value of any cash premium received by Treasury. Non-cash premiums, such as preferred stock, will not offset the reduction of available resources under the Act. As a result, Treasury will evaluate on a case-by-case basis the troubled assets to be covered by the Program to minimize the impact on available funds.

Treasury also notes ongoing efforts to continue evaluating the development of other insurance programs. In doing so, Treasury will be guided by two factors. The first is the Act's accounting for guarantees: that the impact to available Act funds is the same for insuring an asset as for purchasing an asset. The second is the risk of adverse selection arising from the complexity of the troubled assets and the challenges of pricing premiums. Any standardized premium established for a class of troubled assets is likely to be attractive to parties for whom the premium was appropriately priced or under-priced. As a result, the credit risk would be greater than the premium could cover. As a result, premiums should be priced based on an asset-by-asset review of credit risk.

Although comprehensive plans are not yet available, the Financial Stability Plan released on February 10, 2009 by the new Administration does not include reference to ongoing use of the Program. We expect the new Administration would, at most, utilize the Program on a limited case-by-case basis, and as part of a broader arrangement with a financial institution, as was the case with each of Citigroup and Bank of America.

Citigroup and Bank of America Transactions

Treasury completed its first transaction under the Program on January 16, 2009, when it finalized the terms of a guarantee agreement with Citigroup (Citi) that was announced on November 23, 2008. The agreement with Citigroup provides a package of guarantees, liquidity access and capital, and includes two distinct programs, a guarantee from Treasury and the Federal Deposit Insurance Corporation (FDIC) of up to $301 billion and a $20 billion investment by Treasury under the Act's Targeted Investment Program.[8]

On January 15, 2009, Treasury extended the Program to Bank of America (BofA), protecting against the possibility of losses on an asset pool of approximately $118 billion of loans and securities. The majority of these assets were assumed by Bank of America in its acquisition of Merrill Lynch. The assets will remain on BofA's balance sheet. As a fee for this arrangement, Bank of America will issue preferred shares to Treasury and the FDIC. The agreement provides that after additional pool losses of $10 billion, Treasury and the FDIC will guarantee against 90% of the next $10 billion of loss. At any time after the loss on the asset pool reaches $18 billion, the Federal Reserve will make a loan available to BofA for 90% of any subsequent loss.[9]

The Program details are outlined in the chart below.

[8] A summary of the Citigroup agreement terms can be found in Citigroup's form 8-K, available at http://idea.sec.gov/Archives/edgar/data/831001/000095012308016585/0000950123-08-016585-index.idea.htm.
[9] A summary of the Bank of America agreement terms can be found in Bank of America Corporation's form 8-K, available at http://idea.sec.gov/Archives/edgar/data/70858/000119312509009753/0001193125-09-009753-index.idea.htm.

Summary of Terms of the Citigroup and Bank of America Guarantees

	Citigroup	Bank of America
Eligible Assets:	Asset pool consisting of loans and securities backed by residential real estate and commercial real estate, and their associated hedges, and other such financial instruments as the U.S. government (Treasury, FDIC and Federal Reserve, together referred to as USG) has agreed to guarantee or lend against (Citi Pool). Each specific financial instrument in the Citi Pool must be identified on signing of the guarantee agreement. Financial instruments in the Citi Pool will remain on the books of institution but will be appropriately "ring-fenced."	Asset pool consisting of securities backed by residential and commercial real estate loans and corporate debt, derivative transactions that reference such securities, loans, and their associated hedges, and such other financial instruments as USG has agreed to guarantee or lend against (BofA Pool). Each specific financial instrument in the BofA Pool must be identified on signing of the guarantee agreement. Financial instruments in the BofA Pool will remain on the books of institution but will be appropriately "ring-fenced."
Size:	Up to $301 billion of financial instruments (based on valuation agreed upon between Citi and USG).	Up to $118 billion of financial instruments, including cash assets with a current book, or carrying, value of up to $37 billion and a derivatives portfolio with maximum potential future losses of up to $81 billion (based on valuations agreed between BofA and USG).
Term and Coverage of Guarantee:	Guarantee is in place for 10 years for residential assets and 5 years for non-residential assets.	Guarantee is in place for 10 years for residential assets and 5 years for non-residential assets. Residential assets will include loans secured solely by 1-4 family residential real estate, securities predominately collateralized by such loans, and derivatives that predominately reference such securities. BofA has the right to terminate the guarantee at any time (with the consent of USG), and the parties will negotiate in good faith as to an appropriate fee or rebate in connection with any permitted termination. If BofA terminates the guarantee, it must prepay any outstanding Federal Reserve loan (described below) in full. Guarantee covers the aggregate incurred credit losses (net of any gains and recoveries) on the BofA Pool during the term of the guarantee, marks and credit valuation adjustments for the BofA Pool (as agreed between BofA and USG). Such losses do not include unrealized mark-to-market losses but do include realized losses from a sale permitted under the asset management template (described below).
Deductible:	Citi absorbs all losses in the Citi Pool up to $29 billion (in addition to existing reserves). Treasury and the FDIC will share losses in the Citi Pool in excess of that amount: Treasury takes the second loss up to $5 billion; FDIC takes the third loss up to $10 billion. All losses beyond Citi's deductible will be shared between USG (90%) and Citi (10%).	BofA absorbs all losses in the BofA Pool up to $10 billion. Treasury and the FDIC will share losses in the BofA Pool in excess of that amount, up to $10 billion. All losses beyond the institution's deductible will be shared between USG (90%) and BofA (10%).
Financing:	Federal Reserve will provide a non-recourse loan facility to Citi, subject to Citi's 10% loss sharing. Federal Reserve will charge a floating interest rate on drawn amounts of OIS plus 300 bp per annum. Interest and fee payments will be with recourse to Citi.	Federal Reserve will provide a non-recourse loan facility to BofA, subject to BofA's 10% loss sharing. Federal Reserve loan commitment will terminate (and any loans thereunder will mature) on the termination dates of USG guarantee. BofA has the right to terminate the Federal Reserve loan commitment and prepay any Federal Reserve loans at any time (with

		consent of Federal Reserve). Federal Reserve will charge a fee on undrawn amounts of 20 bp per annum and a floating interest rate on drawn amounts of OIS plus 300 bp per annum. Interest and fee payments will be with recourse to BofA. BofA may draw on Federal Reserve loan facility if and when additional mark-to-market and incurred credit losses on the BofA Pool reach $18 billion.
Fee for Guarantee — Preferred Stock and Warrants:	Citi will issue a total of $7 billion of preferred stock with an 8% dividend rate. $4 billion of preferred stock will be issued to Treasury and $3 billion will be issued to the FDIC.	BofA will issue to Treasury and the FDIC (1) $4 billion of preferred stock with an 8% dividend rate; and (2) warrants with an aggregate exercise value of 10% of the total amount of preferred stock issued. The fee may be adjusted, as necessary, based on the results of an actuarial analysis of the final composition of the BofA Pool, as required under Section 102(c) of the Act.
Management of Assets:	Citi generally will manage the financial instruments in the Citi Pool in accordance with its ordinary business practices, but will be required to comply with an asset management template provided by USG. This template will include the use of mortgage modification procedures adopted by the FDIC, unless otherwise agreed.	BofA generally will manage the financial instruments in the BofA Pool in accordance with its ordinary business practices, but will be required to comply with an asset management template as provided by USG. This template will require that BofA, among other things, obtain USG approval (not to be unreasonably withheld) before any Material Disposition. A Material Disposition is a disposition of financial instruments in the BofA Pool that creates a loss that, combined with other dispositions of BofA Pool instruments in the same year, exceeds 1% of the size of the BofA Pool at the beginning of the year. This template also will include, among other things, a foreclosure mitigation policy acceptable to USG.
Revenues and Risk Weighting:	Citi will retain the income stream from the Citi Pool. Risk weighting for financial instruments in the Citi Pool will be 20%.	BofA will retain the income stream from the BofA Pool. Risk weighting for the financial instruments in the BofA Pool will be 20%.
Dividends:	Citi is prohibited from paying common stock dividends in excess of $0.01 per share per quarter for three years without USG consent. In granting consent, USG will consider the ability to complete a common stock offering of appropriate size.	BofA is prohibited from paying common stock dividends in excess of $.01 per share per quarter for three years without USG consent. In granting consent, USG will consider the ability to complete a common stock offering of appropriate size.
Executive Compensation:	Citi must submit an executive compensation plan, including bonuses, that rewards long-term performance and profitability, with appropriate limitations, to, and for approval by, the USG.	BofA must submit an executive compensation plan, including bonuses, that rewards long-term performance and profitability, with appropriate limitations, to, and for approval by, USG. Executive compensation requirements will be consistent with the terms of the preferred stock purchase agreement between BofA and USG.
Corporate Governance:	Other matters as specified.	Other matters as specified, consistent with the terms of the preferred stock purchase agreement between BofA and USG.[10]

[10] The preferred stock purchase agreement is available at http://idea.sec.gov/Archives/edgar/data/70858/000119312509009753/dex101.htm.

Impact of the Program

Despite its challenges, the Program can be beneficial to the participating institution, as well as the taxpayer. In exchange for a premium payment, a financial institution that purchases the guarantee will receive the benefits of the original payment stream on a financial instrument that is a troubled asset. A guarantee makes it easier for a financial institution to hold troubled assets to maturity. The mark-to-market effects of declines in market values will be mitigated once the guarantee level is hit, easing pressure to sell as a means of avoiding the risk of future markdowns. If, as has been widely reported, market values currently significantly understate the true economic value of certain assets, a guarantee that facilitates holding those assets to maturity provides significant benefit.

Additionally, the balance sheet benefits may be significant. Troubled assets under the Program are assigned a 20% risk-weighting, reducing the associated capital burden. Longer term, if a guaranteed troubled asset starts to perform, the financial institution would receive the benefit of holding a healthier asset.

Finally, the financial institution retains management of the troubled assets in the Program, enhancing the likelihood of efficient decision-making. If held by Treasury, a new portfolio manager would be responsible for managing a diverse and new pool of troubled assets. The financial institution maintaining ownership retains direct economic incentive to maximize the value of the troubled assets given its ongoing exposure.

A key disadvantage to be carefully considered is the requirement that participating institutions comply with Treasury's executive compensation restrictions, which continue to evolve. Participation requires compliance with executive compensation rules, corporate governance restrictions, mortgage modification plans and asset management guidelines.

Conclusion

Readers of the extensive comments Treasury received following its request for input in October will quickly note the operational challenges of establishing a broad-based guarantee program. Given the criticisms of the Capital Purchase Program, Treasury benefited from having the guarantee alternative available when it needed to provide additional relief to two systemically significant institutions. Although there are no plans to use the Program broadly, and funds allocated to Treasury under the Act are being quickly depleted, we expect Treasury will leverage the Program if the need arises.

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