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Bailing out the Banking System (and the Auto Industry): Wherefore art ye, Messrs. Paulson and Bernanke?

January 2009

Overview

- What was Juliet asking? Why do you have to be a Capulet?
- In this crisis, we are discovering why the Federal Reserve has to be the Federal Reserve—and why the Treasury has to be the Treasury.
- How are they doing? What's to come?

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Overview

Areas to be covered will include:

- Chronology of the Financial Crisis
- The Troubled Asset Purchase Program (TARP)
- The Citibank Bailout
- The Temporary Liquidity Guarantee Program
- Actions by the Federal Reserve
- Restrictions on Executive Compensation

Chronology of Events

IQ 07
- 25 sub-prime mortgage lenders file for bankruptcy

2Q 07
- New Century, the largest sub-prime lender, files for bankruptcy
- Dow closes above 14,000

3Q 07
- Fed begins a series of rate cuts

4Q 07
- President Bush proposes a plan for mortgage lenders to freeze ARMs at their teaser rates for 5 years

IQ 08
- Bear Stearns acquired and Countrywide acquired – both in private "bailouts"

2Q 08
- IndyMac fails
- SEC restricts short selling
- FHFA formed

3Q 08
- Conservator for Fannie and Freddie
- Lehman Bros. files for bankruptcy
- Mutual Fund "breaks the buck"
- WaMu and Wachovia to be sold
- I-Banks become BHCs

4Q 08
- TARP
- CaPP
- TALF
- TLGP
- Bailouts: AIG 2, Citi, Autos

September 2008

- Sept 7 - Takeover of Fannie Mae and Freddie Mac
- Sept 14 - BofA to buy Merrill Lynch
- Sept 15 - Lehman files
- Sept 15 - Reserve Primary Fund “breaks the buck”
- Sept 16 - AIG Bailout (No. 1)
- Sept 19 - Paulson lays out bailout plan (3-page legislation)
- Sept 19 - ABCP Money Market Liquidity Facility
- Sept 21 - Goldman Sachs and Morgan Stanley (BHCs)
- Sept 25 - WAMU fails and is sold to JP Morgan Chase
- Sept 29 - largest one-day drop in Dow history (Paulson plan defeated in House)
- Sept 29 - Treasury Money Market Bailout
- Sept 29 - Citigroup to buy Wachovia

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October 2008

- Oct 3 - Wells Fargo (not Citi) to buy Wachovia (approved Oct 12)
- Oct 3 - Congress passes EESA
- Oct 6 - Mitsubishi UFJ to inject capital into Morgan Stanley
- Oct 6-10 - Worst stock market week in 75 years
- Oct 7 - Fed Commercial Paper Funding Facility
- Oct 8 - Swap lines to central banks
- Oct 10 - G-7 commit to work together
- Oct 11 - IMF warns of systemic meltdown
- Oct 14 - TARP bank bailout announced
- Oct 14 - FDIC’s TGLP program
- Oct 21 - Fed Money Market Investor Funding Facility

November 2008

- Nov 10 - Amex to become a BHC
- Nov 12 - AIG Bailout (No. 2)
- Nov 12 - Treasury announces TARP shift - no purchase of troubled assets
- Nov 21 - Downey and PFF fail and are taken over by US Bancorp
- Nov 23 - Citi bailed out by TARP, Fed and FDIC
- Nov 25 - Fed TALF funding for consumer and small business ABS
- Nov 25 - Fed announces program to purchase $100 billion in direct obligations of GSEs and $500 billion in MBS backed by GSE's

December 2008 and January 2009

- Dec 2 - various Fed lending facilities extended
- Dec 15 - PNC approved to acquire National City Bank (private bailout?)
- Dec 15 - Bernard Madoff scandal surfaces
- Dec 16 - Rate Cut
- Dec 19 - Treasury bailout of GM and Chrysler
- Dec 22 - CIT approved to become BHC
- Dec 24 - GMAC approved to become BHC
- Dec 29 - Treasury buys $5 billion of GMAC preferred stock and lends $1 billion to GM to make further investment in GMAC
- Dec 30 - Fed announces it will begin MBS purchases in January
- Dec 31 - Wells/Wachovia and PNC/National City deals close
- Jan 1 - BofA acquires Merrill Lynch
- Jan 2 - IndyMac sold by FDIC to a private equity consortium

Troubled Asset Purchase Program

Troubled Asset Relief Program
(TARP)

TARP: The Statutory Perspective

- TARP as initially outlined by Treasury to Congress bears little resemblance to the program as implemented to date
- TARP is
  - Authorization for Treasury to buy and insure "troubled assets" held by "financial institutions" (broadly defined to include any institution with significant US operations)
  - Up to $700 billion, of which the first $350 billion has already been used (or earmarked for use)
  - Purchases to be conducted using either auctions or direct purchases:
    - Stated preference for auctions and other "market mechanisms"
    - However, no such auctions appear likely to occur. The TALF, originally announced as an auction-based program, was revised in December to remove auctions from the program
  - TARP provides for a guaranty/insurance program to be developed for troubled assets

TARP: Definitions

"Financial institution" is defined as any institution established and regulated under U.S. laws and having significant operations in the U.S.

- Includes banks, savings associations, credit unions, security brokers or dealers and insurance companies.
- Institutions owned by foreign governments or central banks specifically are excluded.
- Foreign-owned financial institutions are excluded from CaPP but not necessarily from the rest of TARP
- Treasury and the President have interpreted this to include Chrysler and GM
- Commercial mortgage companies are one of the latest groups to request inclusion

"Troubled assets" are defined as either:

- Residential or commercial mortgages and any securities, obligations based on or related to such mortgages.
- Other financial instruments as Federal Reserve and Treasury determine.
  - ➢ The act requires no Congressional approval – only notice
- ➢ Almost all programs to date have fallen into the second category of "other", including CaPP, TALF, Citigroup, AIG and the Auto companies

TARP's Asset Guaranty/Insurance Program

- The statute requires Treasury to establish an Asset Guaranty Program for troubled assets originated prior to March 14, 2008, and to use guaranty fees to fund the "Troubled Assets Insurance Financing Fund"
- The guaranty/insurance provisions were a last minute addition based on Congress' belief that insurance was a more cost effective way of improving the market for mortgage-backed securities
- No meaningful guaranty/insurance program yet, which perhaps isn't surprising given the lack of TARP spending on mortgages and mortgage-backed securities
- Treasury took an insurance role in the Citigroup bailout by taking a "second loss" position to Citigroup
- Treasury announces (Dec 31) that the guaranty/insurance program not to be widely available—and to be applied "with extreme discretion" and to be restricted to "systemically significant" financial institutions risking loss of market confidence

TARP Review

The Plan		The Reality
• Purchase assets with depressed values from financial institutions' balance sheets	→	• Purchasing newly created assets in the form of preferred stock issued by various institutions
• Develop methodology to price the troubled assets	→	• Treasury passes on this issue
• Focus on the mortgage industry	→	• Broader focus on economy as a whole
• Outline programs within 45 days of passage of the Act	→	• Outline programs as needs are identified
• Limit the program to financial institutions	→	• Expand the program to include the auto industry
• $700 billion considered an enormous outpouring of money	→	• $700 billion likely not to be enough

TARP Funds

Initial Allocation:	$350 billion
Less Commitments:	
Capital Purchase Program	-$250 billion (up to)
AIG Investment (Stage 2)	-$ 40 billion
Citigroup Bailout	-$ 25 billion (up to)
TALF	-$ 20 billion
Auto Bailout	-$ 14.4 billion
GMAC	-$ 5 billion
Commitments Subtotal	-$354.4 billion
Excess over Initial Allocation	4.4 billion

A Look at Three Selected TARP Programs

TARP Programs:

Capital Purchase Program (CaPP)

Citigroup Bailout

Auto Bailout

Capital Purchase Program Overview

- Treasury is making capital investments in banks, BHCs and SLHCs by acquiring preferred stock and warrants
- As of Dec 31, 209 investments had closed, representing $162 billion of the $250 billion allocated to the program
- CAMEL-rated 1 and 2 will be eligible; CAMEL-rated 3 judged on a case-by-case basis; CAMEL-rated 4 and 5 probably not eligible
- Regulators continue to develop internal criteria for choosing eligible financial institutions (*e.g.,* long-term viability, funding base, matching private capital)

CaPP: Executive Compensation Restrictions

- Restrictions on executive compensation:
  - Applies to top 5 executive officers
  - Compensation committee must review plans and certify that there is no incentive structure for excessive risk taking
  - No golden parachute payment for involuntary termination, bankruptcy or receivership
  - Clawback of incentive compensation later found to be received based on statements that were materially inaccurate
  - No tax deduction for compensation in excess of $500,000
- See www.mofo.com for other program standards

CaPP: Eligible Institutions

- Thus far CaPP investments limited to banks, savings associations, BHCs and SLHCs. (U.S. subsidiaries of foreign banks not eligible)
- Amex, GMAC and CIT converting to BHCs and SLHCs to participate in CaPP (and in FDIC's TLGP)
- Insurance companies could qualify on their own but thus far limited to BHCs and SLHCs. Examples:
  - AIG, Ameriprise Financial, Nationwide Financial, Principal Financial
- Rush to become SLHCs. Examples:
  - Hartford, Lincoln Financial, Genworth, Transamerica
  - Phoenix Cos. (desire to make acquisition but hasn't done so yet)
- Is this Paulson's "Blueprint"?

Assessment of CaPP Program

- Stated purpose: to promote lending and ease the credit crunch
- However, investments are being made without specific lending requirements. This has fostered vigorous criticism from Congress that program has gone astray.
  - Congress wants credit to consumers and small businesses
  - Regulators want to build up capital cushions
  - Banks cite dearth of creditworthy borrowers
  - Regulators encourage use of TARP capital for consolidation
- Was the abandonment of TARP's original focus unwise?
- Are separate programs (and more money) necessary for capital enhancement and easing the credit crunch?

Bailout of Citigroup

November 2008

Citigroup Bailout: Terms

- Citigroup protected for 10 years against loss from a pool of assets on its balance sheet:
  - Pool consists of $306 billion of loans and securities backed by residential and commercial real estate and related assets (intended to be the "sludge")
  - Citigroup absorbs the first losses on the pool, in an amount equal to its existing reserves held on the pool + $29 billion
  - Thereafter, each dollar of loss split 90/10 between the USG and Citigroup
    - Treasury to take first $5 billion of USG loss through TARP
    - FDIC to take the next $10 billion in loss
  - Fed to fund the remaining pool of assets with a non-recourse loan (subject to Citigroup's 10% loss-sharing)
- Fee to Treasury and the FDIC = $7 billion of 8% preferred stock
- Treasury to invest $20 billion in TARP funds to acquire 8% preferred stock, with same general terms as in CaPP
- Warrants to Treasury at $10.61 per share (with aggregate exercise price of $2.7 billion)

Citigroup Bailout: Restrictions

- Citigroup to implement the FDIC's mortgage modification program
- Citigroup not to issue dividends in excess of $0.01 per share per quarter without consent
- If dividends not paid for six dividend periods, Preferred has the right to elect two directors
- In addition to the CaPP executive compensation limitations already imposed on Citigroup – any executive compensation plan that rewards long-term performance and profitability must be approved by the US Government

Bailout of GM and Chrysler

December 2008

Auto Bailout by Treasury: Some Observations

- $17.4 billion for GM and Chrysler in short-term bridge loan
- Treasury acted only after Congress stalemated

  > "While the purpose of TARP and EESA is to stabilize the financial sector, the authority allowed us to take this action. Absent Congressional action, no other authority existed to stave off a disorderly bankruptcy of one or more auto companies."

- The extensive conditions and "game plan" required by Treasury (and earlier required by Congress) is, in part, a reaction to the lack of conditions imposed on financial institutions receiving TARP money
- Newly authorized TARP money for financial institutions likely to have long strings attached

Auto Bailout: GMAC Integrated into the Bailout

- GMAC - $211 billion in assets and critical to financing of GM dealers and customers
- GMAC controlled by private equity firm Cerberus
- Dec 24 - Fed approves GMAC to become a BHC, on condition that it increase capital, to be accomplished through debt/equity swap in process
- Dec 29 - Treasury invests $5 billion in preferred stock of GMAC
- Treasury lends $1 billion to GM, with condition that it be invested in an additional $1 billion in GMAC preferred stock
- GMAC investment characterized by Treasury as part of the "automotive industry financing program"

Initial Reviews of TARP

GAO Report on TARP-December 2008

- Under EESA, GAO required to report on TARP every 60 days.
- Key Recommendations to Treasury:
  - Monitor activities of those who receive CaPP funds to determine if their activities are consistent with the purposes of CaPP and ensure an appropriate level of accountability and transparency
  - Monitor and enforce compliance with executive compensation requirements
  - Formalize communications strategy to ensure that external stakeholders (*e.g.,* Congress) are fully informed about the program
  - Facilitate a smooth transition to the new Administration
  - Expedite hiring to ensure that Treasury has sufficient resources to manage the program

GAO Report on TARP

- Continue to develop and implement a comprehensive system of internal controls to protect taxpayers' interests and ensure program objectives are met

- Issue final regulations on conflicts of interest "quickly" and review and renegotiate mitigation plans to enhance specificity and compliance

- Institute a system to effectively manage and monitor the mitigation of conflicts of interest

Congressional Oversight Panel: Back to Juliet!

- The Congressional Oversight Panel was formed under EESA
- Its report is in the form of questions to be asked and answered through the TARP review:
  - Who got the money?
  - What have they done with it?
  - How has it helped the country?
  - How has it helped ordinary people?
- The Panel asks 10 questions that focus on the above questions

Treasury’s Dec 30 Response to the COP

Question 1: What is Treasury’s strategy?

- **Answer**:
  - To achieve the three “critical objectives”:
    - Stabilize financial markets and reduce systemic risk
    - Support the housing market by avoiding preventable foreclosures and supporting mortgage finance
    - Protect taxpayers

- **Perspective**: The response focuses on actions taken to date. The request for an understanding of the strategy was, in part, an effort to understand what might be done next. For that, we will have to wait for the new Administration.

Treasury's Response (cont'd)

Question 1b: What specific facts caused Treasury to change its strategy—from purchasing mortgage-backed securities to providing capital to financial institutions?

- Do we need liquidity? Confidence? To re-value assets—and, if so, up or down?

- **Answer**:
  - Dramatic changes in LIBOR-OIS (overnight index swap rate) spread - a key gauge of funding pressures and perceived counterparty credit risk - Typically one-month spread between 5 – 10 basis points
    - September 1: 47 bp spread
    - September 18 (Paulson introduces bailout package): 135 bp spread
    - October 3 (EESA enacted): 263 bp spread
    - October 10: 338 bp spread
    - October 14: CaPP announced
  - Also during this period: Shut down of the commercial paper market, 3-month Treasuries dipped below zero, and a money market mutual fund "broke the buck" for only the second time in history, precipitating a $200 billion net outflow of funds from that market.

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Treasury's Response (cont'd)

- In light of crisis, need to move as aggressively as possible:
  - CaPP faster (illiquid asset purchases take longer to execute) [Query: is this so?]
  - Capital investment provides more "bang" for the buck
  - To be effective, asset purchases need to be done on very large scale: given $250 billion allocated for CaPP, Treasury asks whether there was sufficient capacity remaining in TARP to buy assets.

- Note: Fed has allocated $500 billion to buy mortgage backed securities backed by the GSEs + $100 billion to buy direct GSE obligations.

Treasury's Response (cont'd)

Question 2: Is the strategy working to stabilize markets, to enhance credit availability for the economy generally?

- How will Treasury achieve "price discovery" for impaired assets? Is it efficient to provide capital to all viable banks, regardless of business profile?

- **Answer:**
  - Treasury responds that its efforts have prevented a series of financial institution failures; reduced risk of default among financial institutions as measured by a decline in the average credit default swap spread for the eight largest U.S. banks of 240 basis points since before Congress passed the EESA; decline in 1-month and 3-month LIBOR-OIS spreads of 220 and 145 basis points, respectively, since the law was signed and about 310 and 240 basis points, respectively, from their peak levels before the CaPP was announced.
  - Treasury noted that it will monitor the impact of CaPP on lending.
- **Perspective**: The response focuses on the integrity of financial institutions - and not fully on questions raised.

Treasury's Response (cont'd)

Question 3: Is the strategy helping to reduce foreclosures?

- How did low interest rates offered to new homebuyers help existing homeowners? Why wasn't foreclosure relief a condition of CaPP investments (as it was for the Citigroup bailout)?

- **Answer:**
  - Yes. Preventing the failure of Fannie Mae and Freddie Mac preserved a source of 70% of mortgage originations and mortgage rates remain affordable.
  - The HOPE NOW Alliance estimates that roughly 2.9 million homeowners have been helped since July 2007; more than 200,000 homeowners a month now avoid foreclosure
  - The streamlined loan modification program has the potential to keep hundreds of thousands more struggling borrowers in their homes at an affordable monthly mortgage payment.

- **Perspective**: Fannie and Freddie are prominently featured as a key part of the U.S. mortgage industry and the key to preventing foreclosures. The calls to eliminate or fully disengage from the GSEs is quickly becoming a distant memory.

Treasury's Response (cont'd)

Question 4: What have financial institutions done with the taxpayers' money?

- **Answer:**
  - Treasury is working with the banking regulators to develop appropriate measurements, and Treasury is focused on determining the extent to which the CaPP is having its desired effect.
  - Treasury noted that many institutions have used the funds to stabilize their balance sheets by adding loan loss reserves.

- **Perspective**: Critics are unlikely to let this drop. The program was sold on the grounds that it would free up banks to lend. But recent GMAC experience might be helpful to Treasury.

Treasury's Response (cont'd)

Question 5: Is the public receiving a fair deal on preferred stock acquired with CaPP funds?

- **Answer:**
  - The financial crisis would have been far worse without Treasury's actions
  - Treasury believes that CaPP investments over time will be good investments for the public. At present:
    - On an accrual basis, the preferred stock is at or near par
    - On a mark-to-market basis, some preferred stock may have decreased in value as equity markets have experienced pressure since the program began
    - The warrants have positive value

Treasury's Response (cont'd)

Question 6: What is Treasury doing to help the American family?

- Total U.S. household debt now exceeds annual national personal income. Is increasing credit to American families through TALF destructive or helpful?

- **Answer:**
  - Stabilizing the financial system provides families with reliable sources of financial services, including savings and investment for retirement (*e.g.,* 401k accounts), access to affordable credit for education, business development, and daily necessities
  - The Fed's TALF programs should help to provide affordable credit card lending
  - Consumers are being helped through the stabilization of the money market mutual fund industry through Treasury's guarantee and the Fed's credit support
  - The support provided to Fannie Mae and Freddie Mac has helped credit markets

Treasury's Response (cont'd)

Question 7: Is Treasury imposing reforms on financial institutions that are taking taxpayer money—*e.g.*, UK style reforms?

- **Answer:**
  - CaPP (unlike UK) is voluntary and only for "viable" institutions
  - CaPP imposes limitations on paying dividends and executive compensation requirements
  - The AIG investment imposed additional terms and conditions, including a change in management and more stringent executive compensation, corporate expenses and lobbying restrictions
  - Treasury is working to develop a comprehensive compliance program to ensure that institutions adhere to executive compensation provisions

Treasury's Response (cont'd)

Question 8: How is Treasury deciding which institutions receive the money?

- Concerns that "too-big-to fail" encourages excessive risk-taking
- Concerns that there is an oversupply of banking: consolidation should be encouraged.
- Concerns that prudently managed banks are losing their competitive edge as less risk-adverse banks rebuild their balance sheets.

- **Answer:**
  - The program is designed for "healthy" institutions
  - Treasury's CaPP application process is rational and fair

Treasury's Response (cont'd)

Question 9: What is the scope of Treasury's statutory authority?

- If auto manufacturers are "financial institutions," what is excluded?

- **Answer:**
  - EESA defines a "troubled asset" to include any financial instrument (*e.g.,* preferred stock and warrants) the purchase of which is necessary to promote financial market stability.
  - Treasury relies on EESA's broad definition of "financial institution."

Question 10: Is Treasury looking ahead? What are the contingency plans if the economy gets worse?

- **Answer:**
  - Treasury is actively engaged in developing additional programs to strengthen the financial system so that sufficient credit is available.

TARP: What's Next?

- Treasury announcements:
  - November 12: No TARP purchases were planned of troubled assets related to real estate
  - November 14: banks may need additional capital beyond CaPP, given their holdings of troubled assets. Would seek to leverage TARP with private capital. No details yet.
  - November 25: funds are needed to improve consumer access to credit and TALF was announced
  - December 19: Congress will need to release the remaining TARP funds to support financial market stability
  - December 31: Guarantee program under the Insurance provision of EESA will have limited use

TARP 2009

- Political as well as market developments will impact future TARP developments
  - Congress likely to require more accountability - and more relief for "Main Street" - before releasing more TARP funds
  - The additional $350 billion will depend on the ability of the new Secretary to lay out a viable plan with more detail than was required in October
  - The Treasury's Office of Financial Stability will need to respond to the report of the GAO and the Congressional Oversight Panel before more money is spent
    - GAO reports are now due every 60 days
    - Congressional Oversight Panel reports are now due every 30 days
  - Backlog of Capital Purchase Program applications will need to be addressed
  - Transition to a new Administration
- *UNLESS*, Treasury is diverted again by another looming failure/ crisis . . .

Temporary Liquidity Guarantee Program

The FDIC's

Temporary Liquidity Guarantee Program

(TLGP)

TLGP Overview

- Announced on the same day as Treasury's CaPP and the release of further information about the Federal Reserve's commercial paper funding facility
- The announcement followed a reported near shut-down of inter-bank lending. Such events, however, are opaque to Main Street in the short term and the choices of policy makers are still being questioned
- The TLGP consists of two basic components:
  - a temporary unlimited guarantee of funds in non-interest bearing transaction accounts at FDIC-insured institutions
  - a temporary guarantee of newly issued senior unsecured debt (Debt Guarantee Program) by banks and bank holding companies and bank affiliates. Insurance companies affiliated with banks and bank holding companies may be covered
- TLGP goals:
  - Strengthen confidence in the banking sector
  - Restore liquidity – with a focus on inter-bank lending

Unlimited Deposit Insurance for Transaction Accounts

- Non-interest bearing demand accounts and non-interest bearing savings accounts into which transaction accounts are swept are fully insured by the FDIC
- The estimated amount of uninsured noninterest bearing transaction account deposits, prior to the TLGP, was between $400 and $500 billion
- Banks must disclose at main office and branches whether they are participating in the Transaction Account Guarantee Program
- Participants are assessed a 10 basis point fee (annualized, but assessed quarterly) on the amount of excess deposits (above $250,000) that are covered by the additional deposit insurance on non-interest bearing transaction accounts

Debt Guarantee Program

- FDIC will guarantee newly issued senior unsecured debt issued on or after October 14, 2008 through and including June 30, 2009

- Issuance of FDIC-guaranteed debt is subject to an issuance cap
  - Issuance cap is 125% of the par or face value of senior unsecured debt, excluding debt extended to affiliates, outstanding as of September 30, 2008, that was scheduled to mature by June 30, 2009.
  - This amount is calculated separately for each individual participating entity within the holding company structure.

- The guarantee will extend to June 30, 2012

- Executive compensation restrictions are not applicable to participants in the TLGP

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Debt Guarantee Program

- Senior unsecured debt includes:
  - federal funds purchased
  - promissory notes
  - commercial paper
  - unsubordinated unsecured notes
  - certificates of deposit standing to the credit of a bank (in other words, the depositor is another domestic or foreign bank)
  - bank deposits in an international banking facility of an insured depository institution
  - Eurodollar deposits standing to the credit of a bank (depositor is another bank)
  - Debt with maturities greater than 30 days

- FDIC guarantee is:
  - Guarantee of timely payment of interest and principal
  - Backed by the full faith and credit of the U.S. government

Debt Guarantee Program

Senior unsecured debt does not include:

- short-term debt (maturity of 30 days or less or “one month” maturity)
- obligations from guaranties
- derivatives
- derivative-linked products
- debt paired with another security
- convertible debt
- capital notes
- negotiable certificates of deposit
- deposits in a foreign currency
- Eurodollar deposits that represent funds swept from accounts held at the institution
- debt marketed exclusively to retail investors

- Senior debt also does not include subordinated or secured obligations
- FDIC-guaranteed debt is exempt from SEC registration under Section 3(a)(2) as debt issued or guaranteed by the United States or an instrumentality of the United States despite the fact that the guarantee expires in three years.

Debt Guarantee Program

- Debt not guaranteed if the proceeds are used to *prepay* outstanding debt or if the debt is extended to an insider or an affiliate.
- Fees:
  - Maturity of 31 – 180 days: 50 basis points per annum
  - Maturity of 181 – 364 days: 75 basis points per annum
  - Maturity of 365+ days: 100 basis points per annum
  - Holding company surcharge: 10 basis points per annum for holding companies whose IDIs represent less than 50% of consolidated assets
- Participating institutions can opt into a non-guaranteed debt program that will permit issuance of non-guaranteed debt, provided it matures after June 30, 2012
- Otherwise, the institution is not able to select which debt is guaranteed. The guarantee applies to debt as it is issued, up to the cap
- FDIC-guaranteed debt must include required disclosure language

TLGP Perspectives

- Fees initially proposed for the program were based on current and prior credit default swap rates for healthy banks
- The FDIC has noted a significant tightening of CDS rates for banks since the launch of the program
- Rolled out quickly, the programs are keeping the staff of the FDIC busy updating FAQs and addressing operational issues

Federal Reserve Programs

Federal Reserve

Financial Crisis Programs

Overview

- With far less fanfare than Treasury, the Fed has already injected trillions of dollars of liquidity into the financial system
- Federal Reserve is using existing as well as new programs
- Many of the new programs are from the Federal Reserve's broad authority under Section 13(3) of the Federal Reserve Act (a power to be used only in "unusual and exigent" circumstances
- New Programs include:
  - Term Auction Facility (TAF)
  - Term Securities Lending Facility (TSLF)
  - Primary Dealer Credit Facility (PDCF)
  - ABCP Money Market Fund Liquidity Facility
  - Transitional Credit Extensions
  - Commercial Paper Funding Facility (CPFF) (with Treasury)
  - Money Market Investor Funding Facility (MMIFF)
  - Term Asset-Backed Securities Loan Facility (TALF) (with Treasury)
  - GSE purchase program
- And the Federal Reserve led both AIG 1 and AIG 2 as well as the Citigroup bailout

Commercial Paper Funding Facility – Overview

- Authorized: October 7, 2008
- Commencement Date: October 27, 2008
- Last Purchase Date: April 20, 2009
- CPFF is funded by the Federal Reserve Bank of New York and managed by PIMCO
- The CPFF will purchase commercial paper of U.S. issuers
- The CPFF was established to enhance liquidity in the commercial paper market to improve overall conditions in the credit markets
- Participants must register and pay a participation fee
- Limited to U.S. issuers, including those with a foreign parent, but excluding municipalities
- Commercial paper is subject to ratings requirements and issuers are subject to issuance caps designed to retain historical funding levels

Term Asset-Backed Securities Loan Facility (TALF)

- Announced: November 25, 2008
- Launch: Expected February 2009
- Last Purchase Date: December 31, 2009
- The New York Fed will offer non-recourse three-year loans to U.S. borrowers collateralized with eligible asset-backed securities (ABS)
- Eligible ABS include recently issued ABS backed by recently originated auto, credit card, student loan and small business loans guaranteed by the SBA
- The borrower cannot pledge as collateral ABS for which it originated the underlying assets
- Treasury will provide $20 billion of TARP resources through purchase of subordinated debt to absorb the first losses
- Participants are subject to the CaPP executive compensation limitations

Federal Reserve Programs: Perspectives

- Commercial Paper Funding Facility
  - Not limited to financial institutions: Designed to provide access to the commercial paper markets to all U.S. issuers
  - Corporations relying on commercial paper financing for operating expenses risked immediate shortages of cash – payroll risk

- Term Asset-backed Liquidity Facility
  - Being designed to restart securitization market for consumer receivables
  - Can this address widespread reports of lower credit lines and higher credit card fees?
  - Catch 22: Banks are being asked to be both more prudent lenders than in the recent past and to increase lending . . .
  - Catch 22 (remix): If the economy needs to deleverage and the savings rate needs to increase, why are we encouraging more consumer borrowing?

ABCP Money Market Fund Liquidity Facility
Money Market Investor Funding Facility

- ABCP Money Market Mutual Fund Liquidity Facility
  - Launched in September and will extend credit through April 30, 2009
  - U.S. depository institutions, U.S. BHCs and U.S. branches and agencies of foreign banks can borrow from the Boston Fed to purchase ABCP from money market funds
  - Designed to provide liquidity to money market funds that need to sell ABCP for redemptions or otherwise. Needed following the collapse of the formerly liquid ABCP market
- Money Market Investor Funding Facility
  - Launched in October and last purchase date is April 30, 2009
  - The fund will purchase certificates of deposit, bank notes and commercial paper from US money market mutual funds
  - The purchases will be funded through the issuance of ABCP by the Fund, backed by the purchased assets
  - Designed to provide liquidity to money market mutual funds
- Both designed to improve liquidity in short-term markets

While we are talking about money market mutual funds . . .

- Before TARP there was the Treasury's Temporary Guarantee Program for Money Market Funds
  - Launched September 29, with the last extension of credit scheduled for April 30, 2009
  - Money market funds can elect to pay a premium and enter the program
  - If a participant in the program "breaks the buck," – investors will be made whole
  - Treasury used the Exchange Stabilization Fund to fund the program. However, through the EESA (enacted two weeks later), Congress required that Treasury reimburse the Exchange Stabilization Fund and not use it for additional guarantee programs for money market funds

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Federal Reserve and Treasury Money Market Programs - Perspectives

- ABCP Money Market Fund Liquidity Facility, Money Market Investor Funding Facility and Temporary Guarantee Program for Money Market Funds
  - Significant Main Street money is held in money market funds
  - Federal Reserve, FDIC and Treasury actions have been designed to stabilize and retain confidence in these investments
  - For example, the FDIC did not guarantee interest bearing accounts under the TLGP because it wanted to avoid a “run” on money market funds
  - An implicit federal guarantee on money market funds? “Deposit insurance” without safety and soundness regulation? . . . Expect a push to increase regulation in this area as regulatory reform becomes a priority in 2009

Restrictions on Executive Compensation

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- TARP requires that sellers of assets to Treasury agree to executive compensation restrictions
  - This includes the CaPP participants, as well as Citigroup and the participants in the TALF
  - There is a *de minimis* exception available to Treasury, but given the scrutiny the Treasury is under, it is unlikely it will be used.
- Restrictions continue to apply so long as Treasury holds equity or debt securities purchased under the CaPP (including pursuant to the warrant), except that the clawback will be required at any time for materially inaccurate financial statements made during the CaPP holding period.

Restrictions on Executive Compensation

No incentives for excessive risk taking

- Compensation committee must meet with senior risk officers, assess compensation structure within 90 days of receiving TARP capital under the CaPP (and annually thereafter) and certify that compensation scheme does not incentivize excessive risk taking by management

Restrictions on Executive Compensation

No golden parachutes to top 5 senior executives:

- Like existing golden parachute rules (280G):
  - Cannot equal or exceed 3x “base pay”
  - If a golden parachute, no deductibility in excess of base pay
- But with some important differences:
  - Applies to involuntary termination (including by executive for Good Reason) without regard to Change of Control
  - Applies in case of bank failure

Restrictions on Executive Compensation

Clawback: **Recovery of any bonus or incentive compensation based on materially inaccurate financial statements**

- Based on SOX model, but with important differences:
  - Applies to a private company;
  - Not limited to a restatement of financial statements: applies to material inaccuracies in financial statements (presumably including call reports), as well as to material inaccuracies in calculation of performance metrics used to calculate bonuses or incentive compensation

Restrictions on Executive Compensation

- For purposes of these rules a "senior executive officer" is defined as the CEO, CFO and the next three highest-paid executives of a public company whose compensation is required to be disclosed under the Securities Exchange Act of 1934, as well as non-public company executive counterparts
- Any individual who is considered a covered executive for any year retains that status for all succeeding years

Limitation of Employer's Deduction for Compensation over $500,000

- No deduction for compensation for executive remuneration of a covered executive that equals or exceeds $500,000
- Deferred compensation earned in one year cannot be deducted in a subsequent year (when it is ordinarily paid to the executive) if it exceeds $500,000 in the year that such deferred compensation was earned reduced by the amount of taxable pay the executive received in the same year
- $500,000 limitation on deductibility applies to private as well as public companies, and also to partnerships
- “Executive remuneration" means all amounts taxable to a covered executive in any taxable year
    - No offset or reduction for amounts that would be excludable under the $1 million cap under Section 162(m) of the Code, such as commissions, performance-based pay, and existing binding contracts

Conclusion: How has the Treasury fared?

- Treasury was forced to act with unprecedented speed in a crisis atmosphere
- Leading economists urged the Treasury to follow the UK's lead and to inject capital into financial institutions instead of buying troubled assets. Treasury is now being heavily criticized for the change in strategy
- The political downside of CaPP is that is does not address directly the mortgage crisis, which was the lightning rod for EESA
- Paulson got off to a bad start with Congress on EESA. Later, decisions were made without broad consultation with Congress
- The election in November created a lame-duck Administration and likely undermined the Treasury Department until the new Secretary takes office
- Worsening economic circumstances have eroded confidence in Treasury
- Ultimately, Treasury is a political arm of the Executive, and is limited by, and subject to, the constraints imposed by the separation of powers

Conclusion: How has the Federal Reserve fared?

- The Fed has acted boldly and has “spent” significantly more money than the Treasury in attempting to bolster the economy and address the credit crunch
- The Fed did not need to go to Congress for legislation and appears to have managed its relationship with Congress better than Treasury
- The Fed’s interventions are “off-balance” sheet - and are not generally seen as public expenditures
- The Fed has appeared to act with a steadier, more consistent hand than Treasury
- The Fed ultimately benefits from being seen as “independent” and non-partisan - and accordingly is likely to continue to be given a freer hand. However, if economic conditions decline, the Fed could be taken to task by Congressional and/or Administration critics