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A Mortgage and Consumer Finance Law Update

10/07/08

Congress Passes Largest Financial Bailout Bill Since the Great Depression

Following two weeks of hand-wringing in Washington, D.C., and market tremors on Wall Street, Congress reversed course and passed a historic $700 billion government bailout of the disintegrating financial industry on October 3, 2008 by a vote of 263 to 171. The Emergency Economic Stabilization Act of 2008 ("EESA"), spearheaded by Treasury Secretary Henry Paulson, went from a three-page proposal to a 450-page catalog, augmented by a long list of tax incentives and spending earmarks. Most importantly, the legislation gives the Treasury Department blanket authority to use the designated funds to purchase, manage and sell "toxic" assets held by financial institutions in order to address the worst credit and liquidity problems in the United States since the Great Depression.

Origins of the Present Crisis
The present crisis originated with the subprime mortgage crisis of 2007. That crisis was itself a product of a housing bubble that peaked in 2005; unusually low interest rates that fed the housing bubble; a correction in the housing market stemming from inflated home values; and the widespread adoption of unregulated subprime lending, which flooded the market with high-risk loans.

The market risk of subprime loans was amplified by loan securitization, which packaged the loans as collateral to back investments bought and sold by third parties on the open market. Because rating agencies gave many of these mortgage-backed securities investment-grade ratings, these securities infiltrated the securities market, which allowed the transfer of risk, but had the effect of embedding that risk deeply and pervasively throughout the financial industry worldwide. When U.S. housing prices began falling over the last year and subprime mortgages began defaulting, these packaged securities lost trillions of dollars in value, and the market was primed for collapse.

Washington initially attempted to shore up the markets in a piecemeal fashion. The Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) were placed into conservatorship in early September 2008. By mid-September, Lehman Brothers announced bankruptcy, and Merrill Lynch was salvaged by Bank of America. The Federal Reserve ("the Fed") lent American Insurance Group ("AIG") $85 billion to prevent a massive insurance system failure. Compounding the problem, by the end of September, federal regulators had seized Seattle-based Washington Mutual and sold its assets to JPMorgan Chase in the largest bank failure in U.S. history.

In response to these dramatic events, Treasury Secretary Henry Paulson and the Bush administration submitted a three-page proposal to give the Treasury Department $700 billion and the widest possible latitude for restoring liquidity to the market. Rejecting such an unsupervised transfer of taxpayer funds to the Bush administration, the House of Representatives modified Paulson's plan by adding oversight and regulation, but this plan also failed on September 29, 2008, and the markets dropped precipitously. Returning to the table to consider a Senate-fashioned bill just days later, Congress finally passed emergency legislation on October 3, 2008.

As he was preparing to cast his vote for the bill, minority leader Rep. John Boehner (R-Ohio) observed, "Let's not kid ourselves: We're in the midst of a recession. It's going to be a rough ride, but it will be a whole lot rougher ride [without the rescue package]," reported *The Washington Post*.

Features of the Bill

Paulson's original proposal sought virtually unlimited authority to immediately spend $700 billion at his sole discretion, without judicial or Congressional oversight. The final version that Congress approved, however, is structured quite differently. EESA provides the Treasury Department with $250 billion that may be spent immediately. Presidential certification is required before an additional $100 billion can be released, and Congressional approval is required for the Treasury to obtain the remaining $350 billion. Importantly, a special inspector general and an oversight board will be created to supervise the Treasury's use of these funds, and the Secretary's actions will be subject to judicial scrutiny through the Administrative Procedures Act, the same as any other federal agency.

The key program within EESA is the Troubled Asset Relief Program ("TARP"), to be managed by the Office of Financial Stability, which will purchase troubled assets from financial institutions. Clearly targeting the origins of the present crisis, EESA's definition of "troubled assets" covers residential or commercial mortgages originated prior to March 14, 2008 — or any securities, obligations, or other instruments related to such mortgages — the purchase of which "the Secretary determines promotes financial market stability." The definition of "financial institution" is drafted very broadly such that it will cover foreign banks with "significant operations in the United States," so long as such institutions are not owned by a foreign government.

Language in the bill indicates Congressional intent that aid be managed so as to keep families in their homes, benefit the widest possible number of financial institutions, and be used efficiently and effectively. The Treasury Secretary is required to publish guidelines governing TARP indicating how troubled assets will be purchased, how asset managers will be selected, and to create benchmarks for selecting and purchasing troubled assets. Ideally, assets purchased under the program are to be managed and eventually sold in order to maximize the return on these properties purchased with taxpayers' funds. Within five years, the President is also required to propose a plan for recovering from the financial services industry any losses incurred as a result of EESA programs.

EESA provides additional support for the HOPE for Homeowners Program, part of the Housing and Economic Recovery Act of 2008, by increasing eligibility of homeowners for participation in that program and enhancing tools to prevent foreclosures. The Treasury Department also gains authority to extend further loan guarantees and credit enhancements to help foster loan modifications.

Is It Enough?

There is widespread disagreement about whether EESA is the right kind of response to the financial crisis, or whether it is substantial enough to truly address the problem. Many view the legislation as a hand-out to an irresponsible financial industry: "taxpayers will still be picking up the tab for Wall Street's party," said Representative Marilyn Musgrave (R-Colo.), reported *The New York Times*. It's also not clear whether Wall Street sensed sufficient relief in the package, as the Dow Jones Industrial Average dropped 157 points immediately after passage, and was down 7.3% for the week — the largest weekly decline in more than six years, according to *The Wall Street Journal*.

While EESA and TARP will clearly give aid and comfort to the hobbled mortgage market, such relief might not occur fast enough to unclog the broader money markets. Even if mortgages and home prices stabilize as projected, if the general economy continues to contract as it has done, jobs and non-mortgage credit will continue to suffer. The breadth of this problem has become evident in Europe and Asia, where rapid government action has become necessary to stabilize and save a number of regionally significant banking institutions immediately after the U.S. passed EESA.

Federal Reserve Chairman Ben Bernanke indicated the necessity of ongoing efforts: "We will continue to use all the powers at our disposal to mitigate credit market disruptions and to foster a strong, vibrant economy," reported *The Economist*. True to his word, on October 7, 2008, the Fed announced a dramatic plan to purchase massive amounts of commercial paper — the short-term debt that the commercial sector depends on to pay employees and buy materials. Falling on the heels of one of the worst days in international financial markets in years, the plan appears to be a pre-emptive strike against fears of an impending global recession.

What This Means for the Mortgage Lending Industry

TARP's definition of the words "troubled asset" is very helpful for the mortgage lending industry, as it specifically directs aid to mortgages and mortgage-related instruments and services. This infusion of capital should relieve some of the pressure created by a rising tide of subprime mortgage defaults and free up resources to resume healthier lending practices. EESA gives the Treasury Department a diverse toolbox for assisting existing mortgage holders, in addition to authority to purchase such assets outright. Depending on the specific mortgage package or related instrument at issue, a lending institution may seek either to be relieved of the instrument entirely by selling it to the Treasury Department under EESA, or the institution may avail itself of EESA assistance options for alleviating the risk of foreclosure. In either case, the lending institution is likely to take a loss against the original terms of freely entered mortgage contracts.

However, even if the mortgage lending industry manages to get out from under the crushing weight of high-risk subprime mortgages, and even if more capital becomes available for lending again, an underlying surplus of housing and ubiquitous foreclosure properties may hobble the market. Additionally, if non-mortgage based credit continues to decline, property values may plummet further as the wider economy slows and jobs are lost, turning more mortgages upside down and further impeding a restoration of the market.

Many inside and outside Congress have called for substantial reform and regulation of the financial services industry to ensure that the U.S. economy is never driven to the brink of ruin like this again. Both Barack Obama and John McCain are calling for such reform, and we can expect either candidate to continue that initiative as President. Chairman of the House Financial Services Committee Barney Frank (D-Mass.) also promised that "[w]e will be back next year to do some serious surgery on the financial structure," reported *The New York Times*.

For More Information

Bill Summary (H.R. 1424):
http://thomas.loc.gov/cgi-bin/bdquery/z?d110:h.r.01424:

Final version of the Bill (H.R. 1424) (PDF):
http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h1424enr.txt.pdf

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