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Congress Passes Economic Rescue Provisions – Key Decisions Left to Treasury

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The U.S. Congress passed economic rescue provisions and President Bush is expected to sign them into law immediately. Today, the U.S. House of Representatives passed the comprehensive rescue/tax extenders bill (H.R. 1424) by a vote of 263 to 171. The U.S. Senate passed it Wednesday night by a vote of 74 to 25.

Passage in the House was an uphill battle after the House rejected similar rescue provisions by a vote of 205 to 228 on Monday. After this stunning failure, the Senate added a comprehensive tax bill and provisions expanding FDIC coverage to accounts worth $250,000 to the failed rescue bill and passed the broader rescue/tax package. The tax package includes a one-year patch for the Alternative Minimum Tax, extensions of expiring tax relief for businesses, energy tax credits, and provisions ensuring that mental health benefits are on par with medical and surgical benefits. The House members who had opposed the rescue bill on Monday and supported it today – mostly House Republicans – attribute their change of heart to many factors including tax relief, expansion of FDIC coverage, mental health parity, and evidence that the economic crisis could get much worse without immediate Congressional action.

What Happens Now?

Now all eyes turn to the Treasury Department. The bill gives the Treasury Department broad authority to spend up to $700 billion to purchase troubled mortgage-related debt from financial institutions. However, the bill does not provide much guidance on some of the most important issues. The bill simply provides that, once the bill is enacted, the Treasury

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has up to 45 days to publish "guidelines" on a number of Troubled Asset Relief Program (TARP) issues including:

"(1) Mechanisms for purchasing troubled assets.
(2) Methods for pricing and valuing troubled assets.
(3) Procedures for selecting asset managers.
(4) Criteria for identifying troubled assets for purchase."

The bill further provides that the "establishment of the policies and procedures and other similar administration requirements imposed on the Secretary by this Act are not intended to delay the commencement of TARP." The Senate Banking Committee staff explained that, because of the exigent circumstances, Congress did not expect the Treasury Department to address these issues through a formal rulemaking process.

If the President signs the bill today, the guidelines should be published by November 17, 2008. However, if the Treasury purchases a troubled asset through the program before that date, the bill requires the Treasury to publish the guidelines within two days after the first purchase. Congressional leadership has indicated that it might return for a lame duck session on November 17th, which would provide an opportunity for Congress to hold hearings on the program guidelines. This, in turn, could lead to changes in the guidelines. Financial industry representatives likely will lobby the Administration and Congress, and otherwise make their views heard, on these important issues over the next few weeks.

A summary of the legislative provisions follows:

Summary of Rescue Provisions Passed by Congress

The bill allows the Treasury Department to spend up to $700 billion to purchase troubled mortgage debt from financial institutions through the Troubled Asset Relief Program (TARP). $250 billion would be made immediately available and an additional $100 billion released upon the Treasury Secretary's certification of need. The President must request the final $350 billion from Congress in writing. Congress could prevent the release by passing a joint resolution of disapproval within 15 days of that request.

The bill also requires the Treasury Department to create an insurance program for troubled assets, including mortgage-backed securities. The program would be paid for by premiums from participating financial institutions.

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In a separately authorized program, the Treasury is given the authority to guarantee the timely payment of principal and interest on troubled assets in return for a negotiated premium. The TARP purchases and guarantees will terminate on December 31, 2009, unless there is a certification of need.

A. Who Can Participate?

Any financial institution, "including, but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any State, territory, or possession of the United States, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Mariana Islands, Guam, American Samoa, or the United States Virgin Islands, and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government," is eligible to participate in the TARP program. Note, however, that the Treasury must take into account the long term viability of the institution in deciding its eligibility.

B. Which Assets Can be Sold?

The Treasury will purchase "troubled assets" which include:

> "(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and
>
> (B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress."

Treasury Secretary Paulson testified that they do not expect to spend more than $50 billion a month. The Treasury and the Fed have indicated that they will deal with one asset class at a time, starting with the simplest and most illiquid. Portfolios of real estate assets consisting of mortgages and OREO do not seem to be high on the list so that for regional or community commercial banks, the TARP does not, at this stage, appear to be much help except as it will encourage sellers and buyers to move closer together on price.

C. Sale Price for Troubled Assets

One of the biggest questions is how much the federal government will pay for troubled assets when there is no market for them. The bill provides a great deal of flexibility to the Treasury in determining the purchase price. The Treasury Secretary Paulson stated that he would create a plan in consultation with experts. The bill does provide that, when implementing TARP, Treasury must consider:

- the interest of taxpayers;
- minimizing the impact on the national debt;
- providing stability to financial markets;
- preserving homeownership;
- the needs of all financial institutions, large and small;
- the needs of local communities; and
- the long term viability of the institution who currently holds the asset.

Further, to ensure that purchases are appropriate, the Treasury must issue regulations to prohibit conflicts of interest.

D. Tax Treatment for Sale of Fannie and Freddie Stock

Financial institutions may treat as ordinary losses any losses on sales of Fannie Mae or Freddie Mae preferred stock which is owned on September 6, 2008, or sold between January 1, 2008, and September 6, 2008. This is expected to help some community banks remain solvent.

E. Taxpayer Protections

The taxpayers' money is protected by provisions that:

- require TARP participants to give Treasury profit-sharing warrants;
- limit executive compensation for TARP participants;
- ensure oversight of TARP transactions by numerous entities;
- require details of all TARP transactions to be posted on the internet within 48 hours;
- require development of a program to recoup TARP losses from the financial industry;
- extend FDIC insurance to bank accounts worth

$250,000; and

- increase oversight over the financial industry.

F. Equity in Participating Institutions

All TARP purchases must give the Treasury non-voting profit-sharing warrants or debt instruments in the selling financial institution. Thus, House Speaker Pelosi is referring to the plan as a "buy-in" where the taxpayers – through the federal government – would have an equity share or interest in participating financial institutions.

G. Limits on Executive Compensation

The Treasury is required to put regulatory limits on the executive compensation and standards for corporate governance of entities participating in TARP. When the Treasury buys the assets directly and no bidding process or market prices are available, entities must observe regulations (i) limiting compensation incentives that are based on risky behavior, (ii) allowing clawback when pay is based on materially false information, and (iii) prohibiting golden parachutes for senior executives.

H. Bureaucracy and Oversight of TARP

The bill creates an Office of Financial Stability within the Treasury Department. Its actions are overseen by a new Financial Oversight Board comprised of the heads of the Board of Governors and the Federal Reserve System, the Treasury, the Federal Home Finance Agency, the Securities and Exchange Commission, and Housing and Urban Development. It also creates the Office of the Special Inspector General for TARP which will oversee the Treasury's actions and provide Congress with quarterly reports. In addition, the Comptroller General of the United States must report to Congress on the program every 60 days and annually audit the program. Further, the Treasury must publicly disclose the details of any transaction within 48 hours. The Treasury's actions are subject to judicial review for arbitrary and capricious behavior. Moreover, it requires the Federal Reserve to report on the use of its emergency lending authority.

I. When Government Sells Assets

The Treasury is expected to sell the assets on the private market when the economy has stabilized. If the federal government ultimately profits from the sale of the purchased assets, profits would pay down the national debt. If there are losses, the federal government is supposed to develop a plan for recouping losses from the financial industry. The bill requires the President to develop a plan for recouping losses and to submit it to Congress within 5 years.

J. Borrower Protections

The bill extends provisions excluding debt forgiveness from taxable income through 2012. It expands eligibility and improves available tools under the Hope for Homeowners program to prevent foreclosures. The Treasury, FHFA, FDIC, and the Federal Reserve must mitigate foreclosures and encourage servicers to modify loans. The modifications could lead to term extensions, rate reductions, principal write-downs, and the removal of other inhibiting restrictions in trusts and other structures. Treasury can use loan guarantees and credit enhancements to prevent foreclosures.

K. Increased Oversight of Financial Institutions

The bill strengthens enforcement procedures relating to fraud and misrepresentation. It also establishes a Congressional Oversight Panel (5 experts appointed on a bipartisan basis) to review the state of financial markets and the regulatory system which must report its findings to Congress every 30 days. On January 20, 2009, it must report on possible re-regulation of the financial markets, including default swaps, and Fannie Mae and Freddie Mac. The bill also requires studies which could lead to future legislation or regulation including studies on the role of leverage and sudden deleveraging of financial institutions and mark-to-market accounting.

back to top

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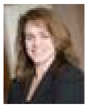
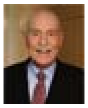


Elizabeth Mundinger Ms. Mundinger's practice focuses on the development and implementation of legislative and regulatory strategy for businesses, corporations, state and local governments, and other public associations.



Harold P. Reichwald Mr. Reichwald is a highly experienced banking and finance attorney whose career encompasses domestic and international matters for banks and specialty finance institutions. His experience comprises a broad range of matters including: governance matters, sophisticated financial transactions such as asset securitization, LBOs, project finance, corporate lending and restructuring; representation of a variety of domestic and foreign financial institutions before the FDIC, Comptroller of the Currency, the Federal Reserve Board and other bank regulatory agencies in connection with new product development, chartering new banks and branches, issues arising out of the bank examination process and enforcement actions demanded by regulatory authorities.