PROSKAUER ROSE LLP

Economic Crisis Response Group

Newsletter

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Edited by
Charles E. Dropkin

Treasury Considers Converting Preferred Shares Issued under TARP into Common Equity

The Treasury Department may convert the preferred shares it holds in banks participating in TARP into shares of common stock if it determines that participating banks need additional capital. This conversion would provide banks with the additional capital necessary to withstand further deterioration in the financial markets without requiring additional funding from Congress. Of the $700 billion appropriated to TARP under the Emergency Economic Stabilization Act of 2008, only $135 billion is currently available for further aid to financial institutions and the Obama Administration believes additional appropriations by Congress are unlikely.

Although no additional cash would be provided to financial institutions, the conversion of preferred shares into common shares would provide an additional capital buffer because shares of common stock rank higher as regulatory capital than preferred shares. As a result of such conversion, the Treasury would no longer receive its quarterly preferred dividend, but it would be entitled to vote its shares of common stock and would, in some cases, become a controlling stockholder in participating financial institutions. Critics of the plan worry about de facto nationalization.

Many U.S. Banks Seek Exit from TARP amid Uncertain Treasury Response

A growing number of U.S. financial institutions are requesting approval to repurchase the preferred shares issued to the Treasury Department under TARP, citing better than expected performance in the first quarter of 2009. Repayment of the TARP funds is expected to place such banks in a stronger competitive position relative to their competitors who remain in the program. Upon repurchase, banks will no longer be subject to restrictions on dividends, executive compensation and certain types of transactions. Under the terms of the program, however, a bank may not repurchase its preferred shares without Treasury Department approval.

The Treasury Department has indicated that it will not approve such requests unless it determines that repayments are in the "national economic interest." In his recent testimony to the TARP Congressional Oversight Panel, Treasury Secretary Geithner stated that banks will be allowed to repay TARP funds only if such repayment would not pose a systemic risk to the financial system. The determination by the Treasury Department and bank regulatory authorities as to whether repayment poses a systemic risk would be based on three considerations. First, repayment must not risk the stability of the financial system as a whole. Second, repayment must not create "incentives for more deleveraging which would deepen the recession." Third, the financial system must have enough capital to "provide credit to support the recovery" after repayment.

Eight banks have repaid TARP funds to date, but the Treasury Department is not expected to make any further decisions with respect to proposed repayments until after the results of the Capital Assistance Program stress tests are released on May 4.

Difficulties for Some Borrowers under Making Home Affordable Loan Modification Program

The loan modification program under the Administration's Making Home Affordable program is designed to address several issues that have plagued past modification programs. However, some homeowners are still having difficulties under the program.

The program includes incentives for loan servicers to offer loan modifications and for homeowners to remain current on their modified payments. The program pays servicers $1,000 for each eligible loan that they modify to encourage them to modify loans rather than foreclose on properties. The program also is intended to limit the high incidence of subsequent defaults by limiting payments to no more than 31 percent of a borrower's gross income and offering balance reductions for each year (up to five subsequent years) that a borrower remains current. Unlike prior programs, eligibility for this program is not limited to borrowers who are already in default. Finally, the program includes standards under which to determine eligibility of participants.

According to borrowers who have tried to contact banks to discuss loan modifications and servicers attempting to implement the program, borrowers in many cases are still encountering barriers to obtaining modifications. For example, servicers have been overwhelmed by calls from borrowers seeking to take advantage of the modification program, and borrowers often are unable to speak with representatives regarding loan modifications in time to prevent foreclosures.

Obama Proposal To Overhaul Student Loans Draws Criticism

As part of his Administration's budget, President Obama has proposed to eliminate federal subsidies to private loan companies. While the Administration has asserted that this change will save $94 billion that can be redirected to borrowers and help more students go to college, critics of the plan and representatives of the student loan industry are skeptical about the merits of the proposal.

Under the current system, students may obtain loans from both the Department of Education and private companies that originate loans with federal subsidies. President Obama's proposal would eliminate the subsidized program, and all loans would come directly from the government.

The student loan industry has argued that the proposal would add billions of dollars to the national debt, result in thousands of job losses in the student loan industry and provide poor service for borrowers who would be forced to deal directly with the Department of Education. Sallie Mae, the nation's largest student loan provider, currently is lobbying on Capitol Hill and has circulated draft legislation that would allow private loan companies to continue to originate student loans but require such loans to be transferred to the Education Department for a fee.

SEC Proposes New Rules on Short Selling

The SEC has proposed several new rules related to short selling and is requesting public comment until June 19. The SEC is considering both market-wide short sale restrictions and rules targeting the short selling of particular stocks that are in rapid decline.

There are two potential market-wide restrictions being considered: a rule similar to the old "uptick" rule, which required that every short sale of an exchange-listed security must occur at a price higher than the previously reported sale price for the security, and a modified uptick rule similar to Nasdaq's former bid test that would use the highest previously reported bid price nationwide as a reference point (rather than the last reported sale price).

In addition to the market-wide rule, the SEC also is soliciting comments on three different types of "circuit-breaker" rules imposing various restrictions on short sales for the remainder of a trading session if a particular security's price declines by 10%. If triggered by such a decline, these rules would restrict short sales by traders with either an uptick or bid test restriction as described above, or an outright short-selling ban on a particular security for the rest of the day.

IMF Forecasts That Global Economy Likely To Shrink for First Time in 60 Years

The International Monetary Fund's recent forecast projected a 1.3% drop in global economic output in 2009. The IMF also predicted that the U.S. economy will shrink 2.8% this year – the biggest such decline since 1946. Among the major industrialized nations studied, Japan is expected to suffer the sharpest contraction this year at 6.2%. China's growth is expected to slow to 6.5% this year, while India's growth is likely to slow to 4.5%.

The IMF expects unemployment to rise broadly, with the jobless rate in the United States expected to average 8.9% this year and climb to 10.1% next year; in Germany, the jobless rate is expected to average 9% this year and 10.8% next year.

The IMF predicts the world's economic output will resume modest growth of 1.9% in 2010, forecasting the U.S. economy to be flat, the economies in Germany and the United Kingdom to continue to contract (though less sharply than in 2009), and growth to resume in Japan, Russia, Canada and Mexico.

CDS Small Bang Protocol

The International Swaps and Derivatives Association (ISDA) will administer a planned Small Bang Protocol for Credit Default Swaps (CDS), setting a standard to settle CDS where there has been a debt restructuring and permitting such CDS to be moved to a central clearinghouse. ISDA's Big Bang Protocol set cash auctions as the means to settle most CDS credit events, but it also eliminated restructurings as credit events for CDS. The Small Bang Protocol bridges this gap for CDS trades in the United States that predate the Big Bang (and thus which still include restructuring as a credit event); it sets cash auctions as the way to settle such restructuring credit events. It also will apply to CDS trades in Europe, where the EU Financial Services Commissioner is pushing for a European clearinghouse for CDS similar to the U.S. CDS clearinghouses that are part of the Big Bang Protocol.

Proskauer's Economic Crisis Response Group includes lawyers with extensive experience representing private and public companies, institutional investors, financial services companies, private equity and hedge funds, lenders, commercial banks and individuals in the complex and interrelated areas impacted by the current financial situation. Our multidisciplinary group brings together the talents of our business and transactional lawyers with our litigation capabilities, particularly as they pertain to acquiring, managing or disposing of distressed assets; issues concerning investments in financial services companies; and complex financial instruments and transactions, including structured finance products; as well as a broad range of other areas such as corporate governance and defense, insurance coverage, reductions in force and other employment and benefit-related issues, securities regulation, and bankruptcy and restructuring matters.

If you have any questions regarding the matters discussed in this Newsletter, please contact any of the lawyers listed below:

Charles E. Dropkin
212.969.3535 – cdropkin@proskauer.com

James P. Gerkis
212.969.3135 – jgerkis@proskauer.com

Jeffrey A. Horwitz
212.969.3229 – jhorwitz@proskauer.com

Bruce L. Lieb
212.969.3320 – blieb@proskauer.com

David A. Picon
212.969.3974 – dpicon@proskauer.com

Stephen L. Ratner
212.969.3290 – sratner@proskauer.com

D. Eric Remensperger
310.284.4590 – eremensperger@proskauer.com

Kathy H. Rocklen
212.969.3755 – krocklen@proskauer.com

David W. Tegeler
617.526.9795 – dtegeler@proskauer.com