PROSKAUER ROSE LLP

Economic Crisis Response Group

Newsletter

April 13, 2009

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Government Accountability Office Urges Treasury Department to Adopt Compliance Procedures for TARP Program

On April 1st, the Government Accountability Office (GAO) issued a report citing the failure of eight banks receiving Troubled Asset Relief Program (TARP) assistance to pay dividends in the aggregate amount of $150,000 to the Treasury, as required by the terms of the program. Banks receiving TARP assistance generally are required to pay quarterly dividends to the Treasury until the TARP funds are repaid. The Treasury Department’s guidelines currently provide that the Government has the right to replace two board members of any participating bank that fails to pay six dividend payments.

The GAO report stated that the Treasury Department has not yet established a process for the collection of required dividend payments and noted that the Treasury has not yet honored its agreement to hire asset managers to oversee the collection of dividend payments and the administration of the warrants issued under the program. The GAO report also criticized the Treasury Department for issuing four contradictory sets of guidelines for determining the exercise price of the warrants issued by participating banks and recommended that the Treasury issue clarifying guidance to resolve discrepancies.

New FASB Rules Ease Mark-to-Market Accounting

On April 2nd, the Financial Accounting Standards Board (FASB) approved new rules to expand exceptions to mark-to-market or fair value accounting rules. The changes, proposed several weeks ago, had been sought by banks and Congress to limit write-downs of the value of certain troubled assets. The rules apply to trading securities, which typically have established market prices (bank loans are governed by different rules). Normally, prices in orderly markets control valuation. FASB rejected a proposal to allow asset owners to completely ignore market prices in inactive markets, instead providing a new definition of an “orderly” transaction, which excludes distressed sales and forced liquidations (so prices in such sales do not control value). In inactive markets, asset owners can now use other information, such as cash flow accounting, rather than the last sale price.

Another FASB revision changed the test for when an asset is “other than temporarily impaired.” Such an asset, which by implication is impaired long term, must be reduced in value based on mark-to-market rules, and these reductions decrease banks’ capital for regulatory tests. Prior to the change, for an asset to be treated as “temporarily impaired,” the owner must have stated that it intended to and was able to retain the asset until its value was no longer impaired. The new rule requires only that the asset owner intends to retain the asset until it is no longer impaired in value and that it is more likely than not that the owner will retain the asset. Also, new guidance states that, for assets that are other than temporarily impaired, losses due to decreases in creditworthiness of obligors and collateral reduce earnings and regulatory capital, but losses resulting from impaired markets do not, though such losses are still disclosed elsewhere in financial statements.

The rules changes are important to mortgage-backed securities (MBS) since they are the trading securities which have probably seen the greatest decrease in trading activity. There is little if any demand for MBS but homeowners are still paying most underlying home mortgage loans, which under the changes opens the door for valuations closer to par based on cash flow accounting for the payments actually being made on the underlying mortgages.

Some investor groups have criticized the rules changes, arguing that the changes give investors less accurate information to use in valuing bank stocks. Congressional committees had given the impression that, if FASB did not act to ease the standards, then Congress itself or the SEC would take action to change standards for bank regulatory accounting. Although Congress called for the changes, the changes provide incentives that conflict with U.S. Treasury plans to induce banks to get troubled assets off their balance sheets, as those balance sheets and income statements now suffer less from retaining the assets.

Treasury Revises Guidelines for Public-Private Investment Program

On April 7th, the Treasury Department issued revised guidelines for the Legacy Securities Program, its plan to restore confidence and liquidity to mortgage- and asset-backed securities markets. Under the Legacy Securities Program, the Treasury would partner with private investment managers to purchase legacy mortgage- and asset-backed securities originated before 2009. The revised guidelines are designed to allow a broader group of private investors to purchase legacy securities under the program.

The Treasury Department indicated that, under the revised guidelines, it may expand the number of asset managers it selects for the program beyond five, the number originally planned, and that firms with less than $10 billion of eligible assets under management may qualify for the program. The revised guidelines also clarify that applicants need not meet all of the criteria set forth in the original announcement to qualify.

In addition, the revised guidelines suggest ways in which smaller firms can partner with eligible asset managers. Smaller firms can partner with fund managers as asset managers, equity partners or fund-raising partners, or may provide services to the fund such as trade execution, valuation and other financial services.

The Treasury Department also extended the deadline for fund managers to submit their applications to Friday, April 24 at 5 p.m. EDT and expects to inform applicants of preliminary qualification on or before Friday, May 15.

U.N. Votes To Hold Major Economic Summit

On April 7th, the U.N. General Assembly adopted a resolution authorizing a high-level conference at U.N. headquarters in New York on the economic crisis and its impact on development. The conference also will focus on reforming and strengthening the international financial system. The conference will be held from June 1st to June 3rd.

In preparation for the summit, a commission of experts, chaired by Nobel Prize-winning Columbia economics professor Joseph Stiglitz, is providing recommendations on international financial structures and practices.

Goldman Sachs CEO Calls for Change in Wall Street Pay

On April 7th, Goldman Sachs Chief Executive Officer Lloyd Blankfein called for new standards on how Wall Street executives are compensated and new regulation of large hedge funds and private equity funds to reduce excessive risk taking.

Appearing at the Council of Institutional Investors, Mr. Blankfein suggested a handful of guidelines, including a longer evaluation horizon for an individual's performance to avoid excessive risk taking and increasing the percentage of pay awarded as company stock as an employee's overall compensation increases. According to Mr. Blankfein, executive compensation in the securities industry should reflect an individual's ability to identify and create value.

Mr. Blankfein also suggested that sufficiently large unregulated pools of capital, including certain hedge and private equity funds, should be put under some degree of government oversight. In addition to these proposals, Mr. Blankfein stated that senior officials in financial companies should be required to keep the bulk of the stock they receive until they retire.

TARP Funds Possibly To Be Granted to Life Insurers

It has been reported that, in the next few days, the Treasury Department is expected to announce its decision to extend funds from the Troubled Asset Relief Program (TARP) to a number of U.S. life insurance companies. It is expected that only insurance companies that own bank-holding companies would be eligible. Insurance companies would have access to funds through the Capital Purchase Program, which was established to allow the Treasury to purchase senior preferred shares of qualifying banks, savings associations, and bank and savings and loan holding companies.

Like other financial institutions, insurance companies have suffered significant losses in their share value and investments in recent months. Several insurance companies have been waiting for months for a decision on whether they could participate in TARP, and in some instances the delay has been costly. In late 2008, Treasury officials told insurers that they could become eligible for federal assistance if they owned bank-holding companies. Therefore, to become eligible for government aid, several insurers entered into agreements last fall to acquire bank-holding companies. However, the Treasury's deliberations over applications have resulted in some insurance companies losing deals that would otherwise have qualified them to participate in TARP.

Protective Life Corp., an insurer based in Birmingham, Alabama, had entered a deal to acquire Bonifay Holding Co., contingent on Protective receiving TARP funds. Bonifay ultimately terminated its deal on or about April 1st, citing "uncertainty" about TARP availability to the insurance company.

Protective is one of five insurers that agreed to acquire a struggling bank or thrift to qualify for TARP funds. There are at least four pending acquisition agreements between troubled financial institutions and insurance companies that hinge on receipt of TARP funds. The Treasury has not yet approved the applications for any of these insurance companies.

ISDA Implements "Big Bang" CDS Protocol

On April 8th the International Swaps and Derivatives Association, Inc. (ISDA) implemented its "Big Bang" Credit Default Swaps (CDS) Protocol. Over 2,000 parties agreed to the Protocol. The Protocol is the last part of the "hardwiring" process to incorporate auction settlement terms into the 2003 ISDA Credit Derivatives Definitions. The Protocol is how ISDA's 2009 March Supplement is applied to existing transactions.

The Supplement contains the new auction settlement terms, and the Protocol incorporates them into existing CDS documentation effective from April 8, 2009. The Supplement adds the auction settlement concept as a settlement method to eliminate the need for credit event protocols to cash settle CDS trades. The Supplement incorporates the resolutions of the 2009 ISDA Credit Derivatives Determinations Committees into standard CDS contracts. These resolutions determine, for example, whether an auction will be held, whether a credit event has occurred, and whether a particular obligation is deliverable. There will be one committee for each of five regions (the Americas, Europe, Japan, the rest of Asia, and Australia/New Zealand); each committee will have ten dealers and five non-dealer (buy-side) members.

The Supplement adds credit event and succession event backstop dates or “look back” provisions into CDS documents to provide common standard effective dates for CDS. The Protocol makes June 20, 2009 the effective date for these backstop dates for existing CDS.

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.

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