

Client Alert

A report
for clients
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G-7 and G-20 Financial Leaders Meet over the Weekend and U.S. Policy Shifts towards Direct Investment in Troubled Institutions; Market Reaction Is Initially Positive

On Friday, October 10, 2008, the G-7 issued a communiqué stating that the current financial crisis called for “urgent and exceptional action” and agreed to a set of principles “to stabilize financial markets and restore the flow of credit.” The G-7 (also known as the Group of Seven) consists of the finance ministers from the United Kingdom, United States, France, Canada, Italy, Japan and Germany. They meet periodically to discuss political and economic issues of mutual concern.

At their meeting in Washington, the G-7 countries agreed to:

- Use “all available tools” to prevent the failure of “systemically important financial institutions”;
- Take “all necessary steps to unfreeze credit and money markets and ensure that banks and other financial institutions” have access to liquidity and funding;
- Ensure that bank deposit programs “are robust and consistent” so that retail depositors will have confidence in the safety of their deposits;

- Ensure that banks are capable of raising capital from both public and private sources “in sufficient amounts to re-establish confidence and permit them to continue lending to households and businesses”;
- Take action to restart the secondary markets for mortgages and other securitized assets, where appropriate; and
- Take these actions in “ways that protect taxpayers and avoid potentially damaging effects on other countries.”

After conclusion of the meeting, a consensus seemed to be building, even in Washington D.C., that there should be a shift in monetary policy away from buying toxic assets to injecting money directly into banking institutions in return for an ownership interest. Given this shift, it is reasonable to expect that at least part of the \$700 billion provided to the United States Treasury from the Emergency Economic Stabilization Act of 2008 will be used for this purpose.

On Saturday, October 11, finance officials from the G-20 (G-7 countries plus such additional countries as Argentina, Brazil, Russia, and India) met to address the financial crisis. Secretary Paulson issued a press release prior to the opening of the meeting of the International Monetary and Financial Committee (“IMFC”) in which he emphasized that “financial turmoil, coupled with significant ongoing financial deleveraging, commodity price shocks, and necessary adjustments in housing and other markets, are causing a sharp slowdown in economic growth.” He also noted that emerging market countries, while having made “impressive strides in strengthening fundamentals,” are not immune from the global financial stress. Accordingly, Secretary Paulson stressed the need for policymakers “to be attentive to implementing measures to support non-inflationary growth, enhance economic resilience, and ensure sound financial systems.”

While noting the need for a global response, in which financial officials from around the world had to take action individually and collectively, Secretary Paulson stated that current action by the United States Treasury Department to address the crisis focused on five areas: liquidity, capital, protecting investors, macroeconomic response and the regulatory environment.

- The Federal Reserve has made additional liquidity available to banks and implemented a temporary guarantee program for U.S. money market mutual funds;
- The Emergency Economic Stabilization Act of 2008 created a \$700 billion pool to purchase or insure mortgage assets or to purchase equity in financial institutions as the Treasury deems necessary to promote market stability;
- The SEC and its foreign counterparts have taken action to address market abuse. The United States also has increased its deposit insurance coverage limits;
- Secretary Paulson also stated that “to facilitate tackling the turmoil and the economic slowdown, macroeconomic toolkits can and should be used as appropriate” based on an individual country’s circumstances; and
- The United States is working with global market participants and regulators to restore stability and confidence in the world’s financial markets.

At the meeting of the IMFC, the G-20 agreed on the need for more cooperation in addressing the financial crisis and issued its own statement indicating that the G-20 countries are “committed to using all the economic and financial tools to assure the stability and well functioning of financial markets.” Brazilian Finance Minister, Guido Mantega, chairman of the G-20, echoing Secretary Paulson, stated that the financial crisis has now “migrated into emerging countries. We are now facing a world wide crisis that must be dealt with by all governments.” The special meeting of the G-20, including the participation of President Bush, is a strong and clear signal of the importance of non-traditional economies, such as Russia, China and India, in addressing the issues presently facing the global economy.

The IMFC emphasized the need to provide financial “stimulus” in the face of the pronounced economic downturn and welcomed the coordinated monetary policy of several central banks. Such monetary policy initiatives should take into account “medium-term consolidation objectives.” The IMFC also noted the challenges posed by higher commodity prices in many countries, even though food and fuel prices have receded from their recent peaks. The IMFC recommended that “shifts in international food and fuel

prices be passed through to domestic markets.” Further, the IMFC stated that progress must be made toward a more multilateral trading system, given the risks to global growth. The IMFC called on members to resist protectionist policies and voiced its support for a conclusion of the Doha Development Round of trade negotiations.

The G-20 ministers stated that the IMF “has a crucial mandate to foster the multilateral cooperation needed to restore and safeguard international monetary and financial stability.” Using its “emergency procedures,” the IMF stated that it stands ready to “quickly make available substantial resources to help member countries cover financing needs.” The IMFC underscored the central role of IMF surveillance in providing “clear, advance warning of risks, helping members to understand the interdependence of their economies, and promoting globally consistent policy responses.” Accordingly, the committee members called on the IMF to “take the lead” in “recommending effective actions to restore confidence and stability.” The IMFC asked the IMF to start this initiative immediately and to report to the IMFC at its next meeting, scheduled for April 25, 2009.

The Federal Reserve Board (“FRB”) announced that it will provide unlimited dollar funds to three other central banks: Bank of England, Swiss National Bank, and the European Central Bank. These central banks will conduct tenders of US dollar funding at 7-day, 28-day, and 84-day maturities at fixed interest rates. Counterparties in these operations will be able to borrow any amount they wish against appropriate collateral in each jurisdiction. Accordingly, the size of reciprocal currency arrangements (swap lines) will be increased to accommodate whatever quantity of US dollar funding is demanded. To assist these operations, the Federal Open Market Committee has authorized increases in the sizes of temporary swap facilities with the Bank of England, the Swiss National Bank and the European central bank. The Bank of Japan may consider similar measures.

On Sunday evening, October 12, 2008, European leaders met at an emergency meeting in Paris and agreed to a plan to increase bank liquidity, granting permission for governments to shore up banks by purchasing preferred shares and guaranteeing inter-bank loans until 2009. Consistent with this objective, which is being hailed in many quarters as the favored one, the government of the United Kingdom is expected to unveil today, October 13, 2008, a plan under which that government could obtain control of two large banks – Royal Bank of Scotland PLC and HBOS PLC—as well as a capital injection into Lloyds Bank. The United Kingdom could invest as much as €50 billion in those three banks. Governments in other parts of the world also acted on Sunday to restore confidence in their economies, with Australia, New Zealand, the United Arab Emirates and Saudi Arabia all reportedly moving to guarantee bank deposits. Germany is expected to inject €400 billion to guarantee bank

borrowings. with €100 billion earmarked for the government's stake in the banks.

The upshot of the past weekend of financial policy making appears to come down to one thing, as noted in *The Wall Street Journal*: “Developed countries are investing directly into the banking system, acting to insure bank deposits, guarantee certain bank debt, and in some cases to nationalize banks.” Secretary Paulson is working on Treasury's own plan to inject capital directly into banks, in line with similar moves announced by Prime Minister Gordon Brown of the United Kingdom and other European nations.

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