PROSKAUER ROSE LLP

Economic Crisis Response Group
Newsletter

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Economic Crisis Response Group

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Stress Test Results Indicate U.S. Banking System Needs $75 Billion Capital Infusion

On May 7, the Treasury Department, Federal Reserve Board, Federal Deposit Insurance Corporation and the Comptroller of the Currency issued a joint statement revealing the results of stress tests conducted on the 19 largest U.S. bank holding companies (“BHCs”). The Federal Reserve has determined that 10 of the 19 BHCs will be required to raise a combined $75 billion in additional capital. The stress tests were conducted by the Federal Reserve and other federal bank regulatory authorities as part of the Supervisory Capital Assessment Program (“SCAP”).

Federal Reserve Chairman Bernanke said that the SCAP tests were a one-time event and do not represent a new capital standard for BHCs. There are currently no plans to extend the tests to smaller financial institutions. According to the test results, the BHCs currently have sufficient Tier 1 capital, or core capital, which is primarily comprised of common stock and disclosed reserves or retained earnings, but will need to improve the quality of their capital to withstand a further economic downturn. All 10 of the undercapitalized BHCs will need to raise Tier 1 common capital, a more stringent measure of capital that strips out the value of any preferred or non-voting stock from Tier 1 capital. The SCAP tests focus on Tier 1 common capital in addition to Tier 1 capital because common equity is the first layer within the capital structure to absorb losses and offers protection to more senior forms of capital.

All 19 BHCs currently have levels and compositions of Tier 1 capital well in excess of the regulatory minimum. For purposes of the SCAP tests, regulatory authorities assumed certain adverse economic conditions and estimated that, such conditions, aggregate losses among the 19 BHCs in 2009 and 2010 could total $600 billion, with mortgage loans and consumer loans accounting for 70% of the potential losses. The Federal Reserve and other bank regulatory authorities used these results to determine the extent to which each BHC would need to alter the current amount and/or composition of its Tier 1 capital to be able to comfortably exceed minimum regulatory requirements at the end of 2010 under these adverse economic conditions. The capital buffer for each BHC is sized to achieve a Tier 1 risk-based ratio of at least six percent and a Tier 1 common risk-based ratio of at least four percent at the end of 2010 under these adverse economic conditions.

Any BHC required to augment its capital buffer is required to submit a detailed capital plan for approval by its primary regulator, in consultation with the Treasury, by June 8. If approved, the BHC must implement the plan on or before November 9. Any BHC that is unable to raise the required amount of capital from private sources by November may access capital available under the Treasury's Capital Assistance Program. In addition, each BHC is required to review its existing management and board of directors to ensure that the firm has the necessary expertise to manage the risks presented by the current economic environment.

Bernanke Cautiously Optimistic about U.S. Economy

On May 6, Federal Reserve Chairman Ben Bernanke testified before the Congressional Joint Economic Committee that the contraction of the U.S. economy seems to have slowed. However, Mr. Bernanke also forecast that the U.S. economy could perform well below its potential for some time to come.

Mr. Bernanke noted that consumer demand may be stabilizing and the housing market is showing signs of reaching a bottom. He stressed that a full recovery would probably take time, partly because "businesses are likely to be cautious about hiring, implying that the unemployment rate could remain high for a time, even after economic growth resumes." Mr. Bernanke stated that indicators of business investment "remain extremely weak" and that commercial real estate conditions are "poor."

In response to questions regarding the Federal Reserve's strategy to end its aggressive steps to stimulate the economy and how the Federal Reserve Banks will manage their $2 trillion in assets, maintain political independence and avoid inflation once the economy is on more solid footing, Mr. Bernanke stated that: "I just want to assure the American people that we are very focused, like a laser beam . . . on this issue of the exit and of making sure that we have price stability in the medium term. It's very important for us to provide a lot of support for this economy right now because it needs support, but at the same time we understand the necessity of winding this down in an orderly way at the appropriate moment so that we will not have inflation problems on the other side."

Treasury Department to Impose Additional Conditions for Repayment of TARP Funds

Sources close to the Treasury Department have revealed that regulatory authorities will release a complete set of guidelines for repayment of TARP funds. Under these guidelines, financial institutions would need to be adequately capitalized after the repayment of (i) all outstanding TARP obligations and (ii) demonstrate the ability to issue debt without the benefit of the FDIC debt guaranty program.

A number of financial institutions have expressed the desire to repay TARP funds, but the Treasury remains concerned about further deterioration of economic conditions and does not want such repayments to impair the ability of banks to continue lending.

Currently, Congress requires only that banks consult with their primary regulators to obtain permission to repay TARP loans. These new requirements will make it more difficult for banks to exit the TARP program.

Separately, the Senate approved a measure that would make it less costly for financial institutions to exit TARP. The legislation eliminates Treasury's obligation to exercise warrants issued to Treasury in connection with the purchase of preferred stock within ten days of repayment of TARP funds by recipient institutions. If enacted, the legislation would enable the Treasury Department to continue to hold such warrants for exercise at a later date.

Senate Rejects Additional Restrictions on TARP Funds

On May 6, the Senate rejected an amendment to the Troubled Asset Relief Program ("TARP") that would have banned the conversion of securities received for TARP funds into common stock. Lawmakers tried to tack three TARP-related provisions onto a Senate bill designed to protect the financial interests of homeowners.

The proposed ban on the conversion of TARP funds into common stock of the financial institutions that received bailout money was proposed by Republican Senator Jim DeMint and was rejected primarily along party lines. The amendment would have effectively prevented the government from assuming an ownership stake in bailed-out companies, either by converting TARP funds into common equity or through direct purchases of such securities.

Another TARP-related amendment to the housing bill received broad support, and would increase the TARP special inspector general's funding for regulatory oversight of the Public-Private Investment Program, the Term-Asset Backed Securities Loan Facility and other public-private investment initiatives. The third amendment was narrowly defeated, and would have required the Treasury Department to reduce available TARP funds by any amounts paid back by recipients so that the TARP is not constantly replenished.

The Senate will resume consideration of the housing bill on June 5.

Mortgage Lending Regulation Bills Pass House and Senate; Permanent FDIC Insurance Increase Proposed

The Senate recently passed S 896, The Helping Families Save Their Homes Act, that would regulate home mortgage lending. Unlike HR 1106, the House version of this bill, which was passed on March 5, the Senate bill would not permit bankruptcy judges to reduce the principal owed on residential first mortgage loans to the value of the property. While bankruptcy judges already have this power, referred to as "cramdown" with respect to other types of secured loans, residential first mortgage loans are currently excluded to encourage mortgage lending and securitizations.

Senator Richard Durbin's proposed amendment to S 896, which would have added a cramdown provision for residential first mortgage loans, was rejected after extensive debate. Opponents claimed that the amendment would result in increased mortgage interest rates, violate the sanctity of contract, and lead to decreased mortgage lending.

On May 7, the House passed HR 1728, the Mortgage Reform and Anti-Predatory Lending Act, which also has no cramdown provisions. HR 1728 is a much more aggressive and significant change in regulation of home mortgage lending than either HR 1728 or S 896, so it is unclear whether the current House and Senate bills can be reconciled.

Like HR 1106, S 896 would amend the Federal Deposit Insurance Act and the Federal Credit Union Act to make permanent the temporary increase in FDIC insurance coverage to $250,000 from $100,000 per depositor that was enacted in October 2008 under the Emergency Economic Stabilization Act, and would increase the FDIC's and National Credit Union Administration's borrowing authority.

HUD Announces Additional Programs Under the American Recovery and Reinvestment Act

The Department of Housing and Urban Development recently announced several initiatives under the American Recovery and Reinvestment Act of 2009 ("ARRA") that will provide state and local governments and housing authorities with funds to develop affordable housing. These programs include joint initiatives of HUD and the Treasury Department that, collectively, will grant approximately $5 billion to states to finance the acquisition and construction of affordable housing. The Treasury program will grant funds to state housing agencies to enable these agencies to provide cash assistance to developers of qualified affordable housing developments. The related HUD program will award grants to state housing credit agencies through the Tax Credit Assistance Program to fund projects to develop qualified affordable housing developments that may have been put on hold due to the current credit crisis.

On May 4, HUD also announced that it is now soliciting grant applications from state and local governments under the Neighborhood Stabilization Program for an additional $2 billion in ARRA funds for development projects targeting areas that have been most affected by foreclosures; HUD will also be awarding $50 million in technical assistance grants to help grantees manage these neighborhood stabilization programs.

On May 5, HUD announced that it had allocated approximately $1 billion of ARRA funds to nearly 1,200 state and local governments, through HUD's Community Development Block Grant Program ("CDBG"). CDBG generally enables state and local governments to undertake projects to create suitable living environments and provide affordable housing, as well as projects that will create economic opportunities within the community. Recipients of these funds are subject to additional requirements and restrictions imposed by ARRA, such as giving priority to projects that can award contracts within 120 days of the grant agreement and restricting recipients from giving any funds to projects dedicated to construction of casinos, aquariums, zoos, golf courses or swimming pools.

Obama Administration Announces Expansion of Making Home Affordable Program

On April 28, the Obama administration announced details of the Second Lien Program, which will work in tandem with first lien modifications under the Home Affordable Modification Program to help achieve greater affordability for homeowners by lowering payments on their second mortgages. Under this new program, when a Home Affordable Modification is initiated on a first lien, participating loan servicers will automatically reduce payments on the associated second lien according to a pre-set protocol; alternatively, the servicers can extinguish the second mortgage for a lump sum payment determined by a formula established by Treasury.

The Administration also announced programs to incorporate the Federal Housing Administration's Hope for Homeowners into the Making Home Affordable program. Under Hope for Homeowners, mortgage holders must accept a payoff below the current market value of a home, allowing the borrower to refinance into a new FHA-guaranteed loan. Under these new measures, servicers will be required to determine whether a borrower is eligible for a Hope for Homeowners refinancing when evaluating borrowers for a Home Affordable Modification; if the borrower is eligible for such a refinancing, the servicer must offer this option to the borrower. The new measures also include incentive payments for servicers for successful Hope for Homeowners refinancings that are similar to incentives offered under the Home Affordable Modification program.

Proposed Legislation Would Allow Immediate Regulation of Swaps Agreements

On May 4, Senators Carl Levin and Susan Collins introduced a bill entitled "Authorizing the Regulation of Swaps Act of 2009." If enacted, the bill would repeal existing legislation, including portions of the Commodity Futures Modernization Act of 2000, that shields swaps from most federal regulation. Federal regulators would be authorized to regulate the swap markets including credit default swaps, and future legislation could also include specific regulation of swaps. The bill would apply to swaps marketed or traded in the United States and is aimed at providing more reporting and transparency requirements for swaps.

Senators Levin and Collins described the bill as an "interim measure intended to clear the way for more specific swaps requirements," legislation that could be enacted later this year. The bill does not state how swaps will be regulated, but it provides banking, commodities, and securities regulators with authority to regulate all swaps in the United States. Committee hearings on the bill have not yet been announced.

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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