

Economic Crisis Response Group

March 2, 2009

Treasury Department Announces Financial Stability Plan

On February 10, Treasury Secretary Geithner introduced the Financial Stability Plan, a series of programs to be implemented by the Treasury Department, the Federal Reserve and other regulatory authorities to strengthen financial institutions and stabilize financial markets. The Financial Stability Plan includes four principal elements: (1) the Capital Assistance Program to ensure that banks have adequate amounts of “high-quality” capital, (2) the Public-Private Investment Fund, established to purchase “legacy” assets (i.e. mortgage-backed and other collateralized securities that are declining in value and adversely affecting bank balance sheets) from financial institutions, (3) an increase in the size of the Federal Reserve’s Term Asset-Backed Securities Lending Facility, and (4) the Homeowner Affordability and Stability Plan, designed to help prevent residential foreclosures.

Treasury Announces Terms of the Capital Assistance Program

On February 25, the U.S. Treasury Department released detailed terms and conditions for the Capital Assistance Program (“CAP”). A core element of the Financial Stability Plan, CAP consists of (1) a capital assessment conducted by federal bank regulatory authorities to determine whether a banking institution is sufficiently capitalized to withstand a difficult economic environment, and (2) a program for the Treasury to invest in U.S. banking institutions deemed to require additional capital through the purchase of convertible preferred stock.

Under CAP, bank regulatory authorities will conduct mandatory capital assessments of 19 publicly-traded banking institutions with assets in excess of \$100 billion under two stress scenarios. The first is a baseline scenario that reflects, among other things, a 2% decline in GDP in 2009, followed by 2.1% growth in 2010; 8.4% unemployment in 2009, followed by 8.8% unemployment in 2010; a 14% decline in housing prices in 2009, followed by a 4% decline in housing prices in 2010. The second is a more adverse scenario, which assumes a 3.3% decline in GDP in 2009, followed by 0.5% growth in 2010; 8.9% unemployment in 2009, followed by 10.3% unemployment in 2010; a 22% decline in housing prices in 2009, followed by a 7% decline in housing prices in 2010.

Smaller banking institutions that wish to apply for CAP assistance will be subject to the same eligibility requirements used in the Capital Purchase Plan, the program to purchase preferred shares of U.S. financial institutions implemented by the Treasury Department in October 2008. If regulatory authorities determine that a bank is in need of additional capital, the qualifying banking institution may raise the additional capital from private sources within six months from the date of this determination or obtain additional capital under CAP.

The deadline for applications to participate in CAP is May 25, 2009; financial institutions controlled by non-U.S. entities are not eligible. The Treasury will release separate term sheets governing the eligibility of financial institutions that are not publicly traded, organized as subchapter S corporations, or in mutual form.

Obama Administration Unveils Homeowner Affordability and Stability Plan

On February 18, President Obama unveiled a \$275 billion plan, the Homeowner Affordability and Stability Plan, intended to help millions of homeowners refinance and/or reduce their mortgages. Complete details of this plan are expected to be announced on March 4.

The key components of the plan include mortgage refinancing for up to five million homeowners, a \$75 billion "Homeowner Stability Initiative" to assist three to four million "at-risk" homeowners, and measures to promote low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac.

The first part of the plan offers refinancing to homeowners with mortgages that are held or guaranteed by Fannie Mae or Freddie Mac; homeowners with mortgage debt between 80% and 105% of the current value of their homes would qualify for refinancing under this initiative.

The Homeowner Stability Initiative would provide incentives for lenders to modify the terms of mortgages; again, homeowners with mortgage debt between 80% and 105% of the value of their homes. The initiative would only apply to primary residences.

Participating lenders would reduce loan payments to no more than 38% of the borrower's income, and the government would subsidize half the lender's costs if it makes further reductions down to a floor of 31%. The initiative offers incentives (a) to lenders in the form of up-front fees, payable monthly, for each modification meeting the applicable guidelines, as long as the borrower remains current, and (b) to borrowers, in the form of monthly balance reduction payments by the government on mortgage loans. The ability to so refinance mortgages which were sold to securitization vehicles, without triggering a default under notes backed by the cash flow of such mortgages, remains a thorny question.

The Administration's plan also calls for Treasury Department to develop uniform guidance for loan modifications across the mortgage industry, which would be used for the Administration's forthcoming foreclosure prevention plan. All financial institutions receiving assistance would have to agree to follow the guidance, as would Fannie Mae and Freddie Mac, and the principals would be applied where appropriate to other loans guaranteed or held by the federal government.

To increase confidence in Fannie Mae and Freddie Mac, Treasury committed to increase its funding commitment to each of these institutions to \$200 billion from \$100 billion. In addition, Treasury has committed to continue purchasing mortgage-backed securities from these institutions. Finally, Treasury would allow these institutions to increase the size of their retained mortgage portfolios to \$900 billion from \$850 billion to encourage them to offer mortgage loans.

Expansion of the Term Asset-Backed Securities Lending Facility

The size and scope of the Term Asset-Backed Securities Lending Facility has been increased to \$1 trillion, with a potentially broader range of eligible collateral, including commercial mortgage-backed securities and private-label residential mortgage-backed securities.

Bernanke Presents Semi-Annual Monetary Policy Report to Congress; Opposes Bank Nationalization

In remarks to the Senate Committee on Banking, Housing and Urban Affairs on February 24, Federal Reserve Chairman Bernanke said that the measures taken by the Federal Reserve, other U.S. government agencies and foreign governments since September 2008 have helped “restore a degree of stability to some financial markets.” Bernanke highlighted the easing of conditions in the short-term funding and commercial paper markets as well as the increased issuance of investment-grade corporate securities, but acknowledged that most securitization markets “remain shut.”

Bernanke stated that the Federal Open Markets Committee expects the recession to continue through 2009, forecasting unemployment between 8.5% and 8.75% and a decline in real GDP between 0.5% and 1.25%. Bernanke believes that a recovery is possible in 2010 if the United States continues to implement a policy of fiscal stimulus combined with “strong government action to stabilize financial institutions and financial markets.”

Bernanke expressed opposition to the nationalization of banks, arguing that federal regulatory authorities already have sufficient tools to assist banks that need capital. While he acknowledged that the government may continue to own substantial minority stakes in banks, he warned that a seizure of banks would unnecessarily risk disrupting the financial markets.

Insured Banks and Thrifts Lost \$26.2 Billion in the Fourth Quarter; FDIC Closes on a \$1.45 Billion Structured Sale of Distressed Loans; FDIC Extends Restoration Plan

The FDIC announced on February 26 that FDIC-insured banks and thrifts lost \$26.2 billion in the fourth quarter of 2008, the first quarterly loss since 1990, and a decline of \$27.8 billion from the \$575 million that the industry earned in the fourth quarter of 2007. Causes included rising loan-loss provisions, trading losses, and write-downs of goodwill.

On the same day, the FDIC announced the consummated sale of \$1.45 billion of performing and non-performing residential and commercial construction loans in distressed markets through two private/public partnership transactions. The FDIC will receive a portion of all future cash flows from these assets. In the last 12 months, the FDIC has sold a total of \$3.2 billion of assets through five private/public partnership transactions and has stated that it expects to make similar sales in the future.

On February 27, the Board of Directors of the FDIC voted to impose a special assessment on insured institutions of 20 basis points.

Significant Efforts at New Regulation of Financial Institutions

Legislative and regulatory authorities in a number of jurisdictions, including the United States, the European Union and various U.S. states, have recently proposed significant new regulations aimed at various aspects of the world's financial markets, including European proposals to create new regulatory agencies.

In the United States, the Hedge Fund Adviser Registration Act of 2009, currently before the U.S. House of Representatives, would repeal one of the basic exemptions employed by many managers of hedge funds, private equity funds, venture capital funds and fund-of-funds to avoid registration under the U.S. Investment Advisers Act of 1940. If adopted, the bill would require most of these managers to register with the Securities and Exchange Commission. A separate bill introduced in the U.S. Senate would eliminate two of the most commonly used exemptions to registration under the Investment Company Act of 1940, which would result in most private investment vehicles like hedge funds and private equity funds being compelled to register as "investment companies" with the Securities and Exchange Commission. In addition, individual states with significant hedge fund industries, like Connecticut, are considering state-level legislation of these financial actors.

In Europe, a panel set up by the European Commission in response to the financial crisis, recently recommended various measures, including the creation of two new regulatory agencies. This panel proposed a European Systemic Risk Council, chaired by the president of the European Central Bank, that would analyze risks to European financial stability. A new supranational agency would coordinate the efforts of EU member-state regulators and to ensure that European supervisory standards are being implemented in each country. The European Commission will respond to the proposals at a summit in early March and will present several detailed proposals in April.

Developments Regarding Credit Default Swaps and Other Derivatives

After a number of House and Senate hearings regarding the benefits and dangers of credit default swaps (“CDS”) and other derivatives, on February 12 the House Agriculture Committee passed HR 977, the Derivatives Markets Transparency and Accountability Act of 2009. CDS are promises by one party to pay a counterparty to the swap agreement for its real or theoretical losses if the issuer of a security becomes insolvent, fails to pay the referenced debt obligation or suffers a similar credit event.

HR 977, intended to increase transparency and regulation of swaps and futures markets, is the successor to the bill that passed the House (but not the Senate) last year. It sets stringent position limits on futures contracts for physically deliverable commodities, requires OTC derivatives contracts be cleared through designated clearing organizations regulated by the Commodity Futures Trading Commission (“CFTC”), and permits the CFTC, with the President’s consent, to suspend trading in “naked” CDS (CDS in which the party buying protection doesn’t own the underlying credit) whenever an SEC short-selling suspension order is in effect. Proponents of the bill view it as preventing price distortions and excessive speculative trading, while opponents are concerned that it will harm or destroy important markets and sources of liquidity. Other provisions of HR 977 would require foreign boards of trade to share trade data and set position limits on speculative trades of U.S. commodities, provide for new, full-time CFTC employees, provide hedge exemptions only to bona fide hedgers, require the CFTC to report separately the trades of index funds and swap dealers in agriculture and energy markets, and permit the CFTC to correct disruptions in OTC markets for gas and energy.

On February 18, nine large financial institutions and two industry associations--ISDA and the European Banking Federation--committed to use, prior to August 2009, central counterparty clearing for eligible CDS in the European Union.

Related Professionals

- **David W. Tegeler**
- **David A. Picon**
Partner
- **Jeffrey A. Horwitz**
Partner
- **Bruce L. Lieb**