TREASURY ANNOUNCES THE FINANCIAL STABILITY PLAN

INTRODUCTION

On February 10, 2009, Treasury Secretary Timothy F. Geithner unveiled the Obama administration's Financial Stability Plan (Plan) to expand federal bailout efforts and to use the remaining US$350 billion in funds from the Emergency Economic Stabilization Act of 2008 (EESA) passed last fall. The Plan represents an extension of certain of the programs initiated under the Bush administration and depends heavily on investment by the private sector to help relieve the pressure of "toxic" assets currently weighing down the balance sheets of US financial institutions. Under the Plan, an aggregator vehicle, or "bad bank," will be created to acquire and hold the underperforming assets that many believe are at the heart of the current financial crisis. The Federal Reserve's current US$200 billion Term Asset-Backed Securities Loan Facility (TALF) will be expanded to as much US$1 trillion to help unfreeze commercial, credit card, student, and automobile lending markets. Remaining EESA funds will continue to be used to make capital injections into ailing banks following the application of a comprehensive "stress test" to assess the strength of all institutions. An additional US$50 billion will go towards a foreclosure relief program whose details are yet to be released, and a new small business and community lending initiative will be started. These programs are discussed below.

I. FINANCIAL STABILITY TRUST

The US Department of the Treasury (Treasury) will establish the Financial Stability Trust in an effort to strengthen financial institutions so as to permit them to continue and increase lending. The Financial Stability Trust will consist of three elements: (1) a forward-looking assessment of the risks on bank balance sheets and capital needs; (2) a Capital Assistance Program (CAP) to help banks establish a capital buffer, and (3) a separate entity—the Financial Stability Trust—that will manage Treasury's CAP investments in financial institutions.

CAP will be available to an institution that needs capital support after a comprehensive stress test of its balance sheet. CAP fund recipients will be subject to conditions to help ensure that the government assistance is used to generate a level of lending that would not have been possible in the absence of government support. Secretary Geithner has stated that the terms of CAP will be designed to encourage institutions to replace public assistance with private capital as soon as possible. All investments under CAP will be placed in, and managed by, a separate entity known as the Financial Stability Trust.

The federal bank regulators will coordinate the development of a stress test that will bring about forward-looking assessments of exposures on the balance

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sheets of financial institutions. The stress test will assess whether a financial institution has the capital necessary to continue lending and to absorb potential losses. All financial institutions with assets in excess of US$100 billion will be required to participate in the coordinated supervisory review process and comprehensive stress test. In addition, banking institutions with consolidated assets below US$100 billion will be eligible to obtain capital from CAP after a supervisory review.

Under CAP, institutions will receive a preferred security investment from Treasury in convertible securities that they can convert into common equity if needed to preserve lending capacity. The convertible securities will carry a dividend that Treasury will specify at a later date and a conversion price set at a modest discount from the institution's stock price as of February 9, 2009. With supervisory approval, institutions will be allowed to apply to exchange their existing preferred stock issued under the Capital Purchase Program (CPP), established pursuant to the EESA, for the new CAP instrument.

II. PUBLIC-PRIVATE INVESTMENT FUND

The Plan calls for the creation of a Public-Private Investment Fund (PPIF) to acquire underperforming assets—what Treasury calls "legacy assets"—from financial institutions and hold them until they can be resold. The PPIF, which is similar to the "bad bank" structure used with some success in the aftermath of the savings and loan crisis, is designed to relieve banks of the bad assets weighing down their balance sheets, and thereby permit them to resume normal lending. Under the PPIF, private funds would be combined with financing from the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) and used to acquire the legacy assets from banks. Treasury envisions the PPIF's initial capitalization at US$500 billion, but plans to double that amount to US$1 trillion over time. By including the private sector in the PPIF, Treasury intends for competitive market pricing for the assets to emerge, thereby addressing the thorny issue of valuation, while simultaneously, it is believed, better protecting the taxpayers' investment. The addition of government funds, moreover, is intended to allow the private sector to leverage its investments and to help cushion private investors somewhat from downside potential, thereby making the investment more attractive to the market.

III. CONSUMER AND BUSINESS LENDING INITIATIVE

Under the original TALF program, the Federal Reserve planned to lend money, on a non-recourse basis, to holders of certain AAA-rated asset backed securities backed by newly originated consumer and small business loans. A new program, known as the Consumer & Business Lending Initiative, will expand the original TALF plan by increasing the amount available for these consumer and business lending facilities. Under the original TALF program, Treasury was permitted to use US$20 billion to leverage US$200 billion of lending from the Federal Reserve. Under the new Consumer & Business Lending Initiative, the amount allocated for lending is increased to US$100 billion, which can be leveraged up to US$1 trillion. Moreover, the Consumer & Business Lending Initiative expands the initial reach of the TALF program by including commercial mortgage backed securities. Although no specific details were provided, Treasury also indicated that it would consider further expansion of the TALF program to include other asset classes, such as non-agency residential mortgage-backed securities and assets collateralized by corporate debt.

IV. TRANSPARENCY AND ACCOUNTABILITY

Institutions that receive future funding through the Plan will need to comply with new transparency and accountability standards. These conditions will not retroactively affect banks that have previously received assistance under the CPP. When applying for government funds, banks will be required to show how capital assistance will increase lending capacity. The information submitted in the application will be made public upon Treasury's approval of capital assistance. Any contract that a government-supported bank enters with Treasury will be published on the Plan website (at http://financialstability.gov) within five to ten days of the agreement. After a bank receives funding, it must provide Treasury, and ultimately the public, with monthly detailed reports with a summary of the increase in the firm's lending, an accounting of the amount of investment made in asset-backed and mortgage-backed securities, and a description of the market that is being served. These reports will also be published on the Plan website.

Going forward, Treasury will also require capital assistance recipients under new capital access programs such as the

CAP to adhere to stringent commitments and compensation restrictions, including the recently announced Treasury guidelines on senior executive compensation (available at http://treas.gov/press/releases/tg15.htm) and discussed in an Arnold & Porter advisory, "Treasury Announces New Restrictions on Executive Compensation" (available at http://www.arnoldporter.com/public_document.cfm?id=14082&key=15C2#zoom=100). All recipients of CAP funds will also be required to offer mortgage foreclosure mitigation programs, consistent with guidelines to be developed by Treasury, as a condition for the receipt of funds. In addition, institutions will be limited in their ability to use the funds for purposes other than lending. Quarterly dividends may not exceed one cent (US$0.01) throughout the duration of the loan, unless Treasury or the appropriate financial regulator approves an increase in accordance with the institution's capital planning objectives. Institutions will also be restricted from repurchasing shares, as well as from acquiring healthy institutions. Separately, Treasury has announced limitations on political lobbying for bailout funds.

V. HOUSING SUPPORT AND FORECLOSURE PREVENTION

Although details are yet to be announced, Secretary Geithner signaled the Administration's intent to increase housing support and foreclosure prevention efforts through a number of new or expanded programs. The Federal Reserve would continue its purchase of agency mortgage-backed securities to reduce interest rates, while up to US$50 billion of EESA funds would be committed to foreclosure prevention efforts. In addition, industry-wide loan-modification guidelines and standards would be developed to help reduce loan default and foreclosure rates.

VI. SMALL BUSINESS AND COMMUNITY LENDING INITIATIVE

Reflecting the general state of credit markets, US Small Business Administration (SBA) lending has decreased substantially over the past year. The Obama administration intends to announce plans to reverse that trend by financing the purchase of AAA-rated SBA loans, increasing SBA loan guarantees to as much as 90%, and streamlining the SBA lending process.

VII. EXTENSION OF THE TEMPORARY LIQUIDITY GUARANTEE PROGRAM

According to a joint press release issued by Treasury and the federal bank regulators, the FDIC's Temporary Liquidity Guarantee Program has contributed to the gradual easing of liquidity strains on financial institutions. The TLGP will be extended an additional four months—until October 2009—to help provide liquidity to institutions.

We hope that you have found this client advisory useful. If you have additional questions, please contact your Arnold & Porter attorney, or:

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