# THE BAILOUT IN TRANSITION

**DORSEY & WHITNEY LLP**

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## GLOSSARY

"*ABS*" – Asset-backed Securities

"*AIF*"- Automotive Industry Financing Program established by Treasury under TARP

"*AMLF*" – Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility provided by the Federal Reserve Bank of Boston

"*ARRA*" –American Recovery and Reinvestment Act of 2009

"*Board*" - Board of Governors of the Federal Reserve System

"*CAP*" – Capital Assistance Program established by Treasury under FSP

"*CPFF*" – Commercial Paper Funding Facility administered by FRBNY

"*CPP*" - Capital Purchase Program established by Treasury under TARP

"*EESA*" - Emergency Economic Stabilization Act of 2008

"*FDIC*" - Federal Deposit Insurance Corporation

"*Fed Chairman*" - Chairman of the Board

"*Federal Reserve*" - Federal Reserve System

"*FHFA*" - Federal Housing Finance Agency (the regulator of Fannie Mae, Freddie Mac and the Federal Home Loan Bank System)

"*FRBNY*" – Federal Reserve Bank of New York

"*FSP*" – Financial Stability Plan announced by Treasury, FDIC, Federal Reserve, OCC, & OTS, which is essentially a re-packaging, expansion and revision of the programs announced under EESA and TARP.

"*GSE*" – Government-sponsored Enterprise (Fannie Mae and Freddie Mac)

"*HAP*" – Homeowner Affordability Plan proposed by the Obama Administration

"*MMIFF*" – Money Market Investor Funding Facility created by the Federal Reserve

"*OTS*" – Office of Thrift Supervision

"*PPIF*" – Public-Private Investment Fund Program established by Treasury under FSP

"*Secretary*" - Secretary of Treasury

"*SEC*" - Securities and Exchange Commission

"*SIG TARP*" – Office of the Special Inspector General for Troubled Asset Relief Program

"*SSFIP"* – Systemically Significant Failing Institutions Program established by Treasury under TARP

"*TALF*" – Term Asset Backed Loan Facility established by Treasury and FRBNY under TARP

"*TARP*" - Troubled Assets Relief Program created under the EESA

"*TIP*" – Targeted Investment Program established by Treasury under TARP

"*TLGP*" – Temporary Liquidity Guaranty Program established by the FDIC

"*Treasury*" - United States Department of Treasury

# INTRODUCTION

It has been 15 weeks since we released The Bailout Revisited, our previous report on the efforts of the USGovernment to revive our financial markets, colloquially known as the "bailout". There have been numerous developments since, including the inauguration of a new President, a reshuffling of the team of officials who counsel the President and implement the bailout, the passage of additional legislation, several new initiatives and a concerted effort to re-brand the bailout and escape the negative public reaction to the efforts of the Bush Administration.

The purpose of this report is to summarize the new developments in the evolving Federal response to the credit crisis. The focus of this report will be initiatives related to the financial system, rather than broader efforts (e.g., the "Stimulus" legislation) to revive the economy. We will provide an overview of the government's recent actions, and information concerning ongoing and proposed programs. This information is designed to be helpful in seeking to assess the risks and opportunities resulting from the federal government's unprecedented activities in the financial system.

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# I. WHERE HAS ALL THE MONEY GONE?

## A. Capital Purchase Program

The Capital Purchase Program ("CPP") has been the Federal government's primary vehicle to date in its efforts to recapitalize the banking system. As of March 27, 2009, Treasury has provided $198.8 billion in CPP capital to 532 financial institutions. A list of the participating institutions is at http://www.financialstability.gov/docs/transaction-reports/transaction_report_03-30-2009.pdf.

The focus of CPP has been on large institutions. 272 publicly traded banks and holding companies have received CPP funds. $85 billion went to 6 institutions in investments of $5 billion or more. 248 privately held banks and holding companies have also received funds. No funds have yet been provided to Subchapter S banks. In addition, as of April 1, 2009, four banks have returned $328 million of CPP funds. Through the CPP, Treasury is seeking to enhance the capital of U.S. financial institutions in an effort to get credit markets moving again and free the flow of financing to American businesses and consumers.

## B. Targeted Investment Program (Citi Round II)

Treasury released a program description of the Targeted Investment Program (the "TIP") on January 2, 2009, under which the November 23, 2008 investment in Citigroup was made. The November investment in Citigroup provided for protection of losses on assets totaling approximately $301 billion of loans and securities backed by residential and commercial real estate. While the description stated that Treasury will determine eligibility of participants on a case-by-case basis, the TIP is viewed by most as a program directed solely at Citigroup and other participants in the program are not expected.

The stated goal of the TIP is to "foster financial market stability and thereby to strengthen the economy and protect American jobs, savings, and retirement security." Considerations that Treasury may take into account in determining eligibility of institutions in the TIP are focused on whether the size and importance of the institution are great enough that loss of confidence, destabilization or failure of the institution are likely to cause to similar problems throughout the nation's financial and economic system.

Treasury invested further in Citigroup on December 31, 2008. Pursuant to a securities purchase agreement, Treasury purchased $20 billion of securities consisting of 20,000 shares of preferred stock and a warrant to purchase 188,501,414 shares of common stock.

With the stated goal of strengthening its capital structure, Citigroup requested in February that Treasury and other preferred stockholders participate in exchange offers, converting preferred stock into common stock. On February 27, 2009, Treasury announced it will participate in the exchange to the extent that other preferred holders agree to participate. Treasury's participation is subject to the conditions that:

(i) Treasury would convert its security to match dollar for dollar the other private preferred exchanges;

(ii) Treasury would convert up to $25 billion of preferred stock issued under the CPP. The remaining preferred stock issued under the TIP and the asset guaranty program will be converted into a trust preferred security of greater structural seniority, with the same 8% cash dividend rate as the existing issue; and

(iii) Treasury receives the most favorable terms and price offered to any other preferred holder.

The exchange will not increase the size of Treasury's investment in Citigroup. The Chairman of the Board of Citigroup also informed Treasury that the Board will be changed to consist of a majority of new and independent directors as soon as feasible.

Further, Citigroup will be taking part, alongside other banks with over $100 billion in assets, in the "Stress Tests" announced by Treasury as part of FSP (see Section III. A. of this Report). In connection with FSP, Citigroup will be allowed to apply for additional mandatory convertible preferred securities or request conversion of the remaining preferred held by Treasury into these securities, consistent with the terms of the program

## C. Systemically Significant Failing Institutions (AIG)

The primary purpose of the Systemically Significant Failing Institutions Program ("SSFIP") is to provide stability and prevent potential disruption to financial markets and the economy as a whole resulting from the failure of large institutions. The stated considerations for participation focus on the size of the institution and the extent to which failure of such institution could threaten the viability of similarly situated institutions, cause major disruptions to the credit markets and materially weaken the overall economy. The type and form of investment under the SSFIP may be in any financial instrument that the Secretary determines to be a troubled asset. Participants in the SSFIP must comply with limitations on executive compensation, expenditures, bonuses and corporate governance and must also provide securities designed to maximize the benefits to taxpayers.

While the terms of the SSFIP state that Treasury will make decisions on participation on a case-by-case basis, the SSFIP is viewed as targeted solely for AIG. AIG provides insurance to more than 100,000 entities that employ over 100 million Americans, has more than 30 million policyholders in the U.S. and is a significant counterparty to many financial institutions. On March 2, 2009, Treasury and the Federal Reserve announced they would restructure their outstanding assistance to AIG "in order to stabilize this systemically important company in a manner that best protects the US taxpayer." The restructuring is intended to separate the major non-core businesses of AIG and strengthen its finances. While stating that public ownership of financial institutions is not a goal and that it will work to replace government resources with private investments as rapidly as possible, Treasury left open the possibility of further support if markets do not stabilize and improve.

To improve AIG's equity and financial leverage, the restructuring provides for exchange of Treasury's existing $40 billion cumulative perpetual preferred shares for new shares with terms more closely resembling common equity. The new terms provide for non-cumulative dividends and limit AIG's redemption power except from proceeds of the issuance of new equity. Treasury will also create a new equity capital facility, allowing AIG to draw up to $30 billion over time in exchange for non-cumulative preferred stock.

AIG's $60 billion revolving credit facility (the "Facility") established in September, 2008 by the FRBNY, will also be amended. The Facility will be reduced in exchange for preferred interests in two special purpose vehicles created to hold all of the outstanding common stock of two life insurance holding company subsidiaries of AIG. The FRBNY will have certain governance rights in these subsidiaries but AIG will retain control. The valuation of the preferred interests, which may be up to $26 billion, will be a percentage of the fair market value of the two subsidiaries. Under the authority of section 13(3) of the Federal Reserve Act, the FRBNY may also pay up to $8.5 billion to special purpose vehicles established by domestic life insurance subsidiaries of AIG. The proceeds of the transactions described in this paragraph would pay down an equivalent amount of debt outstanding under the Facility and reduce the Facility to $25 billion. The interest rate of the facility is currently three-month LIBOR + 3% with a 3.5% LIBOR floor, but the FRBNY intends to remove the LIBOR floor. Other material terms of the Facility will remain unchanged, including the security interest in a substantial portion of AIG's assets. Lastly, as required by the Facility, on March 4, 2009, AIG issued shares of convertible preferred stock representing an approximately 77.9% equity interest in AIG to a trust for the sole benefit of the Treasury.

### D. Automotive Industry Financing Program

The purpose of the Automotive Industry Financing Program ("AIF") is to prevent a disruption of the automobile industry that may pose a systemic risk to financial market stability and the economy of the United States as a whole. The terms and conditions of the program may include investments in any financial instrument but will require participating institutions to provide warrants or alternative consideration to minimize long-term costs and maximize benefits to taxpayers. Participating institutions must comply with executive compensation and corporate governance t requirements. Eligibility in the AIF is determined by looking at (i) similar considerations as those in the TIP and SSFIP, (ii) the importance of the institution to production and financing in the American automotive industry, and (iii) whether disruption of the institution's operations would have a materially adverse effect on employment, thereby producing negative spillover effects on overall economic performance.

On December 19, 2008, Treasury announced its plan to support General Motors and Chrysler. The terms of the AIF include an interest rate of three-month LIBOR + 3% (with a 2% LIBOR floor). The companies were also required to issue a number of warrants to Treasury equal to 20% of the loan amount divided by the exercise price per share (the 15-day trailing average as of December 2, 2008), provided that the warrants represented no more than 20% of the outstanding equity interest of the company. The terms of the loans require the companies to deliver weekly status reports detailing their cash forecasts, biweekly liquidity status reports and monthly certification that the companies are in compliance with the terms of the loan. On or before February 17, 2009, each company was also required to submit reports detailing, among other items, a plan to achieve long term viability, repay the loan and restructure the company making it economically viable. The terms provided for a loan to General Motors of a total of $13.4 billion ($4.0 billion on December 29, 2008, $5.4 billion on January 16, 2009 and $4.0 billion on February 17, 2009) and to Chrysler of $4.0 billion on December 29, 2008. Thus, as of December 29, 2008, the AIF included $17.4 billion in assistance for domestic automakers.

Additionally, on December 29, 2008, Treasury announced it would purchase $5 billion in senior preferred equity with an 8% dividend from GMAC LLC as part of a broader program to assist the domestic automotive industry in becoming financially viable. GMAC also issued warrants for additional preferred equity in an amount equal to 5% of the preferred stock purchased, paying a 9%

dividend if exercised. Further, Treasury agreed to lend up to $1 billion to General Motors (in addition to the $13.4 billion discussed above) to allow it to participate in a rights offering at GMAC in support of GMAC's reorganization as a bank holding company. That loan is secured and exchangeable at any time, at Treasury's option, into the GMAC equity interests being acquired by General Motors in the rights offering. The ultimate level of funding under this facility is dependent upon the level of current investor participation in the rights offering at GMAC.

On January 16, 2009, Treasury announced it would make an additional $1.5 billion loan to a special purpose entity created by Chrysler Financial to finance new consumer automotive loans. The loan is for five years at a rate of one-month LIBOR + 1% for the first year and + 1.5% thereafter, and is secured by a senior secured interest in newly originated consumer automotive loans with Chrysler Holdings as a guarantor for certain covenants under the loan. The special purpose entity also issued warrants to Treasury in the form of additional notes with similar terms to the loan in an amount equal to 5% of the total loan size. The warrants vest at 20% on the closing date and 20% for each anniversary of the closing date thereafter.

On March 30, 2009, the Administration announced its determination that the plans submitted by General Motors and Chrysler on February 17, 2009, did not establish a credible path to viability for either company and were not sufficient to justify substantial new investment by taxpayers. Due to unsustainable liabilities, the Administration pointed to structured bankruptcy as the best chance at success for both companies. After Rick Wagoner, the Chairman and CEO of General Motors, stepped aside, the Administration announced it will lend General Motors working capital for 60 days to develop a more aggressive restructuring plan. The Administration believes General Motors should be able to emerge a competitive business with more fundamental restructuring than was provided for in the February 17 plan. Less optimistic about Chrysler's prospects than General Motors', the Administration determined that Chrysler will not be viable as a stand-alone company due to its smaller size, lower quality product lines, consumer perception of lower quality products and heavy reliance on trucks and SUVs which are expected to lose market share in the coming years due to the demand for smaller, more fuel efficient cars. However, the Administration did decide to provide 30 days of working capital to give Chrysler an opportunity to reach an agreement for a partnership with Fiat that the Administration feels could lead to viability. If such agreement is reached, the government will consider investing an additional $6 billion to help the partnership succeed.

On March 30, 2009, the Administration also announced a new warranty commitment program with the goal to give consumers considering new car purchases the confidence that their warranties will be honored. The program is open to any domestic manufacturer that chooses to participate and will cover all new vehicles sold during the period in which a participating manufacturer is restructuring. Accounts will be funded with 125% of the projected costs of warranty claims (15% contributed by the manufacturer and 110% contributed by the Treasury). The company holding the funds will be separate from the manufacturer and will pay warranty claims even if the manufacturer goes into bankruptcy or out of business.

### E. New Bank Holding Companies

The passage of EESA spurred various entities to file applications to become Bank Holding Companies ("BHCs") and Savings and Loan Holding Companies. Once approved, those entities became eligible to participate in CPP. Applicants included Goldman Sachs (approved on September 21, 2008), Morgan Stanley (approved on September 21, 2008), American Express Company and American Express Travel Related Services Company, Inc. (approved on November 10, 2008), CIT

Group Inc. (approved on December 22, 2008), GMAC LLC (approved on December 24, 2008), The Hartford Financial Services Group, Inc. (approved as a Savings and Loan Holding Company on January 8, 2009) and Protective Life Corporation (approved on January 15, 2009). As of February 27, 2009, Goldman Sachs, Morgan Stanley, American Express, GMAC (discussed in I. D. above) and CIT had received TARP funds.

These new BHC's may also apply for funds under CAP (discussed in Section III. A. of this Report, provided their application to become a BHC was approved by January 15, 2009, (the same approval deadline used for CPP participation).

### F. The World According to SIG TARP

The EESA created the Office of the Special Inspector General for Troubled Asset Relief Program ("SIG TARP"). SIG TARP is responsible for coordinating and conducting audits and investigations of any program established by the Secretary under the EESA. With the stated goal of providing transparency to the TARP program and the ability to assess the effectiveness of TARP programs, SIG TARP has sent letters of inquiry (LOIs) to each TARP recipient requesting information including:

(i) anticipated use of TARP funds, whether TARP funds were segregated from other institutional funds, actual use of TARP funds to date and expected use of unspent TARP funds; and

(ii) specific plans for addressing executive compensation requirements, including assessments of loan risks and relationship to executive compensation, how limitations on compensation will be implemented and whether such limitations may be offset by changes to other forms of executive compensation.

The letter anticipates quantitative and qualitative responses and requests segregation and preservation of all documents that reference the use or anticipated use of TARP funds. Further, the response must be signed by a senior executive officer and include a statement certifying the accuracy of all statements, representations and supporting information provided.

The responses to the LOIs are subject to the requirements and penalties in 18 U.S.C. § 1001 (False Statements or Entries Generally), which provides for criminal liability and imprisonment of up to five years for knowingly and willfully making any material false, fictitious or fraudulent statement or representation. Further, the certification requirement implicates 31 U.S.C. §§ 3729-2733 (False Claims Act) which (among other things) imposes liability on any person who (i) knowingly presents a false or fraudulent claim for payment or approval to the government, (ii) knowingly uses a false record or statement to get a false or fraudulent claim paid or approved by the government, or (iii) knowingly uses a false record or statement to conceal, avoid or decrease an obligation to pay the government. The False Claims Act authorizes private whistleblowers to file suits on behalf of the government and such whistleblowers can recover up to 30% of the money at stake. SIG TARP recently warned a House subcommittee that the rescue program may be susceptible to fraud, signaling that he will likely be looking closely at any evidence of fraud by TARP recipients. One TARP-related fraud has already been alleged by the SEC against a Tennessee firm accused of defrauding investors of $6.5 million by claiming the funds were invested in TARP and other nonexistent securities.

Due to the potential for liability and the scrutiny by the SIG TARP, companies should be extremely cautious in responding to the LOIs to avoid any misstatement about current and potential future uses of the TARP funds. One key piece of requested information includes whether the TARP funds are segregated. Banks that have not received TARP funds but are subsidiaries of holding companies that did receive TARP funds should avoid signaling that the bank used the TARP funds to support lending activities unless the bank actually received the funds from the holding company and a connection can be established between the receipt of funds and their uses for the purpose disclosed in the response.

**G. FDIC Fund Use Monitoring**

On January 12, 2009, the FDIC became the first bank regulator to require that the banks for which it acts as primary federal regulator (state-chartered banks which are not members of the Federal Reserve) implement processes to monitor their use of capital injections, liquidity support and financing guarantees, as applicable, which were obtained through the financial stability programs established by Treasury, the FDIC and the Federal Reserve. The FDIC stated that since "government funds, capital and guarantees are being used to support banking institutions, banks are expected to document how they are continuing to meet the credit needs of creditworthy borrowers." The goal of the monitoring processes is to determine how participation in these federal programs assisted institutions in supporting prudent lending and efforts to work with existing borrowers to avoid unnecessary foreclosures. The FDIC encouraged institutions to include a summary of such information in shareholder and public reports, annual reports and financial statements, as applicable.

**H. Monthly Bank Lending Surveys**

Treasury launched the monthly bank lending survey as part of its commitment to Congress and the public to provide greater communication and transparency about its programs. With the goal of providing more transparency in the CPP and frequent and accessible information on banks' lending activities, Treasury released its first survey on February 17, 2009, which summarized the lending and other activities of the top 20 CPP recipients.

The first monthly survey tracked lending activity through the first three months of the CPP program, October – December, 2008. Subsequent reports will reflect data monthly. The report concluded that despite the unprecedented financial crisis, banks continued to originate, refinance and renew loans. As a result of the decreasing loan demand and tighter underwriting standards, the 20 reporting banks reported a median decrease of 1 percent in total loan balances. The report also revealed that loan origination and underwriting activities were weak from October to November but picked up from November through December, fueled by falling mortgage interest rates and the FDIC's Temporary Liquidity Guarantee Program. While the report was largely in general terms, a table detailing the types and dollar amounts of loan originations by each of the top 20 recipients was also attached.

## II. WAITING FOR THE REST OF TARP

### A. The Incomplete Sub-S Bank Program

Community banks affected by the financial crisis waited patiently for some of the TARP funds invested through CPP to reach them. Most of these institutions are privately held and many of them are bank holding companies that elected to be taxed as Subchapter S Corporations under the Internal Revenue Code ("Sub-S Banks"). The original CPP terms used preferred stock as the form of investment, and Sub-S banks were left on the sidelines since their tax status limited them to a single class of stock. Many community banks were lenders to the builders and other small businesses that built the new homes and communities made possible by the real estate boom and now find themselves with loans secured by residential real estate in varying stages of development with significantly reduced collateral values. While this situation certainly resulted in a need for assistance, it quickly became apparent that Sub-S Banks would not be a priority.

On January 14, 2009, Treasury announced terms for Sub-S Banks to participate in CPP. If there was any celebration in response to this announcement, it was short lived. To address the single class of stock issue, the Sub-S program terms use subordinated debt ("Sub-Debt") as the form of investment. Since regulatory capital rules treat Sub-Debt as Tier II Capital, an amendment to these capital rules was necessary and in fact, the terms announced by Treasury conditioned any investment on amendment of the applicable capital rules. Two months later, no rule changes have been proposed. In addition to the necessary changes in regulatory capital rules, Federal Reserve policy provides that voting common stock should be the predominant form of capital for a bank holding company. Many Sub-S banks used trust-owned preferred stock to provide additional capital. Some of those banks may not be able to take full advantage of TARP funds, because the TARP funds combined with existing trust preferred will exceed the capital represented by their voting common stock.

Even if these two regulatory capital issues are addressed, Sub-S banks will need two more things to participate in CPP, program documents and an approval. As of the second week of March, Treasury had issued only a term sheet and brief list of FAQ's for the program. The agreements that Sub-S banks will be required to execute, and the details imbedded in those agreements, are still not available. Furthermore it may be the approval that is most difficult thing to obtain. There have been indications that smaller institutions will have to be healthier than their larger brethren, which have already received significant CPP funds and may now receive additional support from the new CAP program. Along with what may be a higher standard in general, some are suggesting the assistance will not be provided if the existing investors in what are often family-owned banks have the resources to invest first, or at least on a matching basis. Despite all of this uncertainty and delay in the Sub-S program, the deadline for filing an application was February 13, 2009.

### B. No Mutual Support

The only institutions faring worse that Sub-S banks under the CPP are mutual savings associations. Essentially owned by their depositors, structuring an investment for these institutions presents unique challenges. The last word for mutual institutions was on January 14, 2009 in the FAQ's for the S-Corp program: "… Treasury continues to work with the federal banking agencies on a solution for mutual companies."

## III. FINANCIAL STABILITY PLAN

### A. Financial Stability Trust - Capital Assistance Plan ("CAP")

Treasury presented the details of the new Capital Assistance Program ("CAP") on February 25, 2009, with the issuance of a Treasury White Paper on the program along with a term sheet and application guidelines. In the initial announcement of the Financial Stability Plan, CAP was grouped along with the implementation of a financial stress test and promise of increased transparency under the new Financial Stability Trust, a separate entity to be established to manage the government's investment in financial institutions. Treasury's White Paper focused on CAP's two core elements, a forward looking capital assessment for banks with assets in excess of $100 billion (the "Stress Test") and access to CAP contingent common equity as a bridge to private capital in the future.

#### 1. Stress Testing Major Banks

The 19 largest U.S. banking organizations, all with assets in excess of $100 billion, are required to participate in a coordinated supervisory planning exercise or Stress Test. At a high level, the Stress Test assesses each organization's capital based on expected losses if economic conditions become worse than generally expected. The results would then be used to determine whether an additional capital buffer would be needed for an organization to absorb losses and continue lending in a more adverse environment. If it is determined that such a buffer is needed, the organization then has six months to raise the necessary capital privately or access the capital made available by Treasury under CAP. Treasury makes clear that the buffer does not represent a new capital standard and need not be maintained on an ongoing basis, presumably because the Stress Test would identify the one time buffer necessary for the organization to survive a "worst case" economic downturn.

The Stress Test uses two economic scenarios to estimate an organization's expected losses over the next two years in their loan and securities portfolios as well as off-balance sheet risk. The "baseline" scenario is based on a consensus outlook from recent professional forecasts. Specifically, real GDP growth and unemployment figures are based on the average of projections published in February by Consensus Forecasts, Blue Chip and the Survey of Professional Forecasters. For the "baseline" scenario, the average annual rates for GDP growth are -2.0% for 2009 and 2.1% for 2010; average annual unemployment rates are 8.4% for 2009 and 8.0% for 2010; and the change in housing prices from $4^{th}$ quarter to $4^{th}$ quarter are -14% for 2009 and -4% for 2010.

The more "adverse" scenario reflects a much deeper and longer recession, with GDP growth and unemployment rates constructed based on the track record of the forecasters used and the forecasters' own current measures of uncertainty, along with change in housing prices constructed using data on year to year variability of housing prices since 1900, as adjusted for macro-economic factors. For the "adverse" scenario, the average annual rates for GDP growth are -3.3% for 2009 and 0. 5% for 2010; average annual unemployment rates are 8.9% for 2009 and 10.3% for 2010; and the change in housing prices from $4^{th}$ quarter to $4^{th}$ quarter are -22% for 2009 and -7% for 2010. Treasury indicates the probability of occurrence of the "adverse" scenario conditions is between 10% and 15%.

Participating institutions then apply these scenarios to project future losses and forecast internal resources available to absorb projected losses, including pre-provision net revenue and reserves. Estimates are then reported by each participating institution, along with supporting information, and then reviewed with regulators to determine the capital buffer needed to allow the institution to remain well capitalized through the "adverse" scenario.

While the Stress Test is required at only the 19 largest institutions, bank examiners are struggling to assess prospective risk and capital needs at all financial institutions, in many cases looking to management to present credible projections of their institution's condition under varying conditions. These projections and the ability to meet projected capital needs can have a significant influence on current examination results and the regulatory path an institution will be placed upon as it confronts the challenges presented over the next two years. For some, this will influence the level of flexibility they will enjoy to pursue profitable business lines and opportunities and for others this may determine their chances for survival.

While standards and circumstances vary drastically across the universe of financial institutions impacted by the current crisis, taking into account the "baseline" and "adverse" scenarios should be a reliable launching point for management to assess the prospective risk faced by their institutions and respond to regulatory inquiries about future capital adequacy and viability.

2. CAP Investments

Institutions that have undergone the Stress Test will have access to additional government funds under CAP. In addition, other publicly traded financial institutions, not controlled by a foreign bank or company, and that engage solely or predominantly in activities permissible for financial holding companies may apply to participate. As with CPP, there is also the promise of term sheets for participation by non-publicly traded, subchapter-S and mutual institutions. The application process is similar to CPP, with initial recommendations required from an institution's primary federal regulator, and for holding companies, the primary federal regulator for the largest subsidiary institution. The CAP application deadline is May 25, 2009. Applications will be kept confidential and, once approved, an applicant will have up to 6 months to close.

CAP investments will take the form of convertible preferred shares that mandatorily convert to common after 7 years and can be converted in whole or in part at the option of the issuing institution at any time prior to that, subject to approval of its primary regulator. CAP preferred qualifies as Tier I capital, is senior to common stock, pari passu with other existing senior preferred shares, carries a $1,000 per share liquidation preference, pays cumulative dividends at a rate of 9% per annum and is immediately transferable. The conversion price is 90% of the average closing price for common stock for the 20 trading day period ending February 9, 2009. In the first two years, redemptions are at par plus accrued, unpaid dividends, and thereafter at the same redemption price unless the as-converted value is greater. So long as CAP preferred is outstanding with accrued unpaid dividends, no dividends may be paid (other than pro rata dividends on pari passu preferred stock) and no stock may be purchased or redeemed by the institution. So long as CAP preferred is outstanding and owned by Treasury or Treasury holds any common stock issued under CAP, common dividends are limited to $0.01 per share per quarter and any repurchases of equity or trust preferred securities requires Treasury approval. Finally, CAP recipients are restricted from pursuing

cash acquisitions of healthy firms until the government investment is repaid, with the exception of supervisor approved restructuring plans.

The amount of CAP preferred will be between 1% to 2% of risk weighted assets, plus the amount of any CAP preferred that will be used to redeem CPP preferred or preferred issued under the Targeted Investment Program. An institution that required capital in excess of these limits will be reviewed as an institution requiring exceptional assistance on a case by case basis and may be subject to bank-specific negotiated agreements.

Along with the CAP preferred, Treasury receives a warrant to purchase common stock with an aggregate market value equal to 20% of the CAP preferred, with the CAP preferred conversion price used to both value the initial issuance and set the warrant price. CAP warrants have a 10 year term, have no restrictions on transfer, and are immediately exercisable. Treasury will not, however, exercise voting rights with respect to shares issued and held by it upon exercise of CAP warrants. CAP preferred and warrants and all underlying common shares will be subject to a shelf registration, piggy back registration rights and national exchange listing requirements.

CAP preferred can be redeemed with the proceeds of a common stock offering with aggregate gross proceeds of not less than 25% of the CAP preferred issue price or additions to retained earnings. After the mandatory conversion date, each year Treasury will make reasonable efforts to sell 20% of the common held by Treasury on the conversion date. The institution will also have the right to repurchase common shares held by Treasury at the greater of the conversion price or market price, based on the average closing price for the 20 day period ending the day after notice of repurchase is given, with the proceeds of a common stock offering or additions to retained earnings. Following repurchase of all Treasury common as described above, CAP warrants and related common can be repurchased at fair market value.

Issuance of CAP preferred is also a Qualified Equity Offering for purposes of TARP CPP, allowing for eligible institutions to effectively exchange TARP CPP funding for CAP. Accordingly, the amount of CAP preferred issued can be increased to the extent proceeds are used to repay TARP CPP, subject to the terms of TARP CPP. Any partial redemption of TARP CPP preferred in the first three years must be at least 25% of the issue price. If, on or prior to December 31, 2009, an institution completes one or more Qualified Equity Offerings with aggregate gross proceeds of not less than 100% of the issue price of the CPP preferred and the CPP preferred is redeemed, the number of shares of common stock underlying the CPP warrants then held by Treasury shall be reduced by 50% of the number of shares originally underlying the warrants (taking into account all adjustments). Following the redemption of all CPP preferred held by Treasury, the issuer shall have the right to repurchase CPP warrants held by Treasury at fair market value. If an institution does not then exercise its right to repurchase the CPP warrants, Treasury has indicated that it will seek to liquidate its registered warrants as soon as possible.

Treasury is allowing banks to convert CPP investments to CAP to try to improve the market assessment of the capital provided by the government under TARP. After the CPP kicked off, many stock analysts focused on common equity ratios, suggesting, among other things, that CPP funds should be held primarily as a reserve against losses and that, to the extent capital was needed for growth or acquisitions, new common equity was preferred. It

appears that Treasury considered the market's focus on common equity when structuring CAP to be convertible to common at the option of the issuer. By allowing CPP to essentially convert to CAP, an issuer can eliminate the CPP preferred stock issue, if the economics of the exchange make it worth while.

CAP recipients are also required to participate in the mortgage foreclosure mitigation programs described in Section V. and are subject to the executive compensation limitations described in Section IV.

3. Reporting & Disclosure

The February 25, 2009, White Paper and accompanying documents did not address the reporting, restrictions and enhanced disclosure requirements referenced in Treasury's initial Fact Sheet on the Financial Stability Plan. The Fact Sheet indicated that recipients of exceptional or CAP assistance will be subject to new monitoring requirements, including a requirement to show how every dollar of capital received is enabling them to preserve or generate new lending compared to what would have been possible without government assistance. The Fact Sheet also indicated that as part of the applications process, institutions must submit a plan for how CAP funds will be used to preserve and strengthen their lending capacity and that these plans will be made public once the institution's CAP investment is approved and closed. The CAP application guidelines and forms do not, however, contain any reference to such a plan requirement.

CAP recipients will also be required to provide detailed monthly reports of their lending, broken out by category, showing new business and consumer loans, assets and mortgage backed securities purchases and a description of the lending environment in the local communities they serve. These monthly reports will also include a comparison to their estimate of what their lending would have been without government assistance. Public companies will be required to file similar reports on an 8-K simultaneous with the filing of their 10-Q's and 10-K's. Treasury will also publish key metrics showing the impact of the Financial Stability Plan on key markets.

## B. Public-Private Investment Fund

PPIF was initially announced as part of FSP as a program designed to help cleanse bank balance sheets of toxic loan and mortgage-backed assets, thus marking a return to the original purpose of EESA and TARP, the purchase of toxic assets. On March 23, 2009, the initial details were announced of what is now to be a joint Treasury and FDIC program for legacy assets. PPIF is organized around three principles, maximizing the impact of each taxpayer dollar, shared risks and profits with the private sector and private sector price discovery. PPIF is also divided into two programs, based on the type of eligible assets, the Legacy Loans Program and the Legacy Securities Program, each designed to provide additional liquidity by establishing a markets for legacy assets currently burdening the balance sheets of financial institutions.

1. Legacy Loans Program. The Legacy Loans Program combines private and Treasury equity with FDIC-guaranteed debt. In general, Treasury and private investors provide the equity investment in a Public Private Investment Fund ("Fund"), with private investor control of asset management and FDIC oversight. Additional funding for each Fund is provided by

the issuance of debt, supported by a secured guarantee from the FDIC, and with a maximum debt to equity ratio of 6 to 1. Treasury will also receive warrants in each Fund as required by EESA, although the specifics of these warrants have not been established. While the default equity investment will be 50% from private investors and 50% from Treasury, the Treasury portion can be decreased, subject to a minimum Treasury investment to be determined. Since this program is being established in part under the FDIC's systemic risk authority, if there are insufficient funds to cover the FDIC's guarantee obligations, all insured banks could be assessed to cover the shortfall.

The process for participation in the Legacy Loans Program begins with an interested bank working with its primary regulator to identify eligible assets to be offered for purchase. The specific criteria for eligible assets has not been finalized, but are expected to initially focus on pools of real estate loans and real property. The FDIC will then work with private contractors to analyze the asset pool being offered and determine the level of guaranteed debt to be offered, subject to a maximum debt to equity ratio of 6 to 1. The private equity portion of the asset pool along with a committed level of debt financing will then be auctioned to qualified bidders. The amount of the winning bid, along with the amount of FDIC debt and Treasury equity investment, will determine the amount to be offered to the bank offering the asset pool. The bank will then have the option of accepting or rejecting the proposed sale price. If accepted, the bank will be paid in cash and/or FDIC guaranteed debt. Potential PPIF investors are pre-approved and may not bid on pools that include affiliate assets. Executive compensation restrictions are not applicable to passive Fund equity investors but presumably will apply to those active in the management of a Fund. Each Fund must also agree to yet to be specified waste, fraud and abuse protections.

At this point certain features of the Legacy Loans Program are out for comment. These include, among other things, the full range of assets to be included, whether private equity interests will be transferable, whether private investors will be identified, whether the government's share of profits should increase over a certain pro rata hurdle return, whether assets of multiple banks can be combined into a single pool, how to accommodate the participation of smaller banks and whether a value and cost should be attributed to servicing rights. The program is also subject to minimum requirements for eligible assets and what is referred to as the FDIC Guaranteed Secured Debt for PPIF Term Sheet, neither of which is yet available.

2. Legacy Securities Program. The Legacy Securities Program is a Treasury program that combines Treasury equity with TALF debt funding to establish Funds that will in turn invest in residential and commercial mortgage backed securities. Eligible securities will initially include non-agency securities issued before 2009 that were AAA rated when issued. Each Fund will combine private and Treasury equity with optional Treasury senior debt and will be managed by a private fund manager with discretion over the acquisition and disposition of eligible fund assets. In general, Treasury and private investors provide equal equity investments in a Fund established and managed by an approved fund manager. Additional funding for the PPIF is provided by the issuance of senior debt in an amount up to 50% of the fund's equity, or up to 100% if yet to be established restrictions on asset level leverage, redemption rights, disposition priorities and other requirements are met. A Fund may also fund the acquisition of eligible assets using Legacy TALF or other Treasury or private debt funding, provided that Treasury and private equity are leveraged proportionately.

Treasury will also receive warrants in each Fund as required by EESA, although the specifics of these warrants have not been established. While the default equity investment is to be 50% from private investors and 50% from Treasury, the Treasury portion can be decreased.

Unlike the Legacy Loan Program, the Legacy Securities Program starts with the fund manager not the selling bank. Eligible fund managers must apply for preliminary approval by April 10, 2009. Initially, it is anticipated that only 5 fund managers will be approved. To be considered for approval, a fund manager must have (a) an established track record in the targeted asset class; (b) a minimum of $10 billion under management in the targeted asset class; (c) the capacity to raise $500 million of private capital; (d) the operational capacity to manage the fund; and (e) headquarters in the U.S. In general, a long-term buy and hold strategy must be employed, although alternative strategies with limited trading will be considered. Once approved, the fund manager will submit and then execute on a plan to raise the necessary capital and then receive Treasury equity and senior debt, which will generally be drawn down in tranches. Fund managers may receive a fee from private equity investors and a fixed fee based on the percentage of Treasury equity, payable only out of distributions. Executive compensation restrictions are not applicable to passive PPIF equity investors but presumably will apply to fund managers and other investors active in the management of the Fund. Fund managers also may not cause a Fund to bid on affiliate assets. Each Fund must also agree to yet to be specified waste, fraud and abuse protections. Treasury will retain the right to cease funding of committed but undrawn debt and equity, in its sole direction.

### C. Consumer and Business Lending Initiatives

In an effort to address the near total collapse of the asset-backed securities ("ABS") market, Treasury and FRBNY launched an expanded Term Asset Backed Loan Facility ("TALF") on March 3, 2009 as a component of the Consumer and Business Lending Initiative and published terms for the first funding, scheduled to take place on March 25, 2009. Originally announced on November 25, 2008, and expanded and revised on February 10, 2009, the latest revisions further broaden and expand TALF. According to Treasury, it now has the potential to generate up to $1 trillion in consumer and business lending by providing financing to investors to purchase AAA–rated tranches of ABS.

Under TALF, the FRBNY will make non-recourse loans to eligible borrowers for a term of not more than three years to be secured by eligible ABS collateral. Borrowers have the option to pre-pay TALF loans but may not substitute collateral. Payments of principal and interest on eligible collateral must be used to pay the TALF loan which will not be subject to mark to market requirements.

In order to be eligible for a TALF loan, a borrower must be a U.S. company (including certain hedge, private equity and mutual funds managed by an investment manager that has a principal place of business in the U.S.) or a U.S. branch or agency of a foreign bank that maintains reserves with the Federal Reserve Bank.

Eligible ABS collateral must be U.S. dollar denominated, issued on or after January 1, 2009, not synthetic, and have ratings generally in the highest investment-grade category by two nationally recognized statistical rating agencies without the benefit of a third party guarantee. Rating downgrades of ABS collateral will not affect existing TALF loans. The requirement that sponsors must agree to comply with the executive compensation requirement of the EESA has been

eliminated. Applicable haircuts depend on the type of ABS and the associated risk as well as the expected life of the underlying assets.

The assets underlying TALF-eligible ABS must be auto loans (including both retail loans and leases), federally guaranteed and private student loans, credit card loans or small business loans guaranteed by the U.S. Small Business Administration made to US-domiciled obligors. Treasury and Federal Reserve are considering expanding the universe of TALF eligible assets to include commercial mortgages, rental, commercial and government vehicle fleet leases, equipment loans and leases and collateralized loan and debt obligations (CLOs and CDOs).

A fixed amount of TALF loans will be offered monthly with a minimum amount for each loan of $10 million. Loans will be contingent on receipt by FRBNY's custodian of the eligible ABS collateral and payment of a loan fee. FRBNY will develop procedures to assess any high risk ABS that may be pledged for a TALF loan.

FRBNY will create a special purpose vehicle (the "SPV") which will enter into a forward purchase agreement with FRBNY under which the SPV will, if the borrower defaults, purchase the collateral securing the defaulted TALF loan at a price equal to the loan principal amount plus accrued, unpaid interest. Treasury will invest in the SPV, and thereby share in gains and losses, by using TARP funds to purchase from the SPV subordinated debt to finance the first $20 billion of assets purchased and additional funds will be lent to the SPV by FRBNY. Cash flows from assets held by the SPV are to be used first to repay FRBNY loan which is senior to the TARP loan. The TALF loan program is scheduled to terminate on December 31, 2009, unless extended by the Federal Reserve Board.

### D. Extended TLGP

The implementation of the FDIC's Temporary Liquidity Guaranty Program ("TLGP") has become one of the better examples of the "learn as you go" nature of the government's response to the financial crisis. Even after a final rule was issued, and as late as a few days before the deadline of opting out of TLGP programs, applicable rules were being effectively amended through revisions to the FDIC's FAQ's for the program.

A recent example of such clarifications and apparent course changes occurred early this year. In the January updates to the TLGP FAQ's, the FDIC addressed the issue of whether guaranteed debt could be used to provide capital to a subsidiary bank. While indicating on the one hand that such a use was permissible, the FDIC went on to caution against using short term guaranteed debt to fund longer term capital needs. The FDIC then declared that TLGP "was not intended to be a capital enhancement program…" and that the purpose was to restore liquidity to the intermediate term debt market. Despite this, on February 27, 2009, the FDIC issued an interim rule modifying the senior debt guarantee program to allow the coverage of debt that is convertible into the issuer's common shares at a specified date no later that the expiration date of the FDIC's guarantee, upon application to and approval of the FDIC and the institution's primary federal regulator.

On March 17, 2009, further changes to the TLGP senior debt guarantee program were announced in an interim rule issued by the FDIC. These changes extend the deadline for issuance of guaranteed debt by certain issuers from June 30, 2009, to October 30, 2009 and extend the guarantee period for certain debt issued after April 1, 2009 from June 30, 2012, to December 31, 2012. The

interim rule also establishes surcharges on debt issued under the program with a term of more than one year.

### E. Small Business and Community Lending Initiative

With the expectation that small businesses will be the driving force behind any economic recovery, the Obama Administration has developed the Small Business Community Lending Initiative ("SBCLI"). The goal of the SBCLI is to facilitate the flow of credit to entrepreneurs and small business owners by (i) expanding the secondary market for small business loans, and (ii) making it easier for borrowers to obtain United States Small Business Administration ("SBA") financing, while simultaneously (iii) proposing new bank reporting rules and small business tax reform.

Last fall, the securitization market for SBA loans ("SBA Securities") began to slow considerably. Recognizing that an active market for SBA Securities provides community banks with new capital to make additional loans, the first facet of the SBCLI enables the federal government to commit up to $15 billion to reinvigorate this market. Specifically, Treasury will begin making direct purchases of SBA Securities packaged since July, 2008, and stand ready to purchase SBA Securities packaged between now and the end of 2009.

The second facet of the SBCLI involves the implementation of two key provisions of ARRA. Specifically, the SBA will increase its guarantee of loans under Section 7(a) (standard SBA small business loans) over $150,000 from 75% to 90%, and temporarily eliminate borrower and lender fees for loans under Section 7(a) and Section 504 (first mortgage loans). These measures are expected to provide lenders with the security and incentives they need to start lending to small businesses in need of capital.

The final facet of the SBCLI describes (i) Treasury's calls for new bank reporting requirements and (ii) guidance from the IRS on provisions contained in ARRA. With respect to reporting, the Secretary proposes to require all banks to disclose their total lending to small businesses on at least a quarterly, as opposed to an annual, basis. With respect to tax provisions in ARRA, the IRS will issue guidance and seek to implement those that will improve liquidity for small businesses through lower taxes. Among other things, these provisions will (i) allow businesses over a certain size to carry losses back up to five years, (ii) allow small businesses to immediately write off up to $250,000 of qualified investments in 2009, (iii) reduce small businesses' estimated tax payments from 110% to 90% of previous year's taxes, and (iv) allow investors to exclude 75% of their capital gains from investments in small businesses for five years.

### F. FinancialStability.gov

The Administration has launched a new web site, FinancialStability.gov, to help publicize the FSP. With respect to investments, FinancialStability.gov (i) hosts all contracts under the FSP within 10 days of their completion, and (ii) lists the value of all capital investments made by Treasury, as well as the quantity and strike price of warrants received, the schedule of required payments to the government and when the government is being repaid. Furthermore, and where available, the terms and pricing of these investments will be compared with recent market transactions. In addition to the specific details concerning the use of taxpayer funds, FinancialStability.gov also hosts information detailing the various programs aimed at restoring stability to the financial system and measuring their effects on the applicable markets, essentially replacing Treasury's EESA web page in this role.

## IV. EXECUTIVE COMPENSATION

### A. EESA

Section 111(b) of EESA directed the Secretary of Treasury to adopt "appropriate standards for executive compensation and corporation governance" to govern institutions from which direct purchases of troubled assets were made and in which Treasury obtained a "meaningful equity or debt position." These standards were specifically to include (A) limits on incentive compensation to "senior executive officers" to ensure there are not incentives for such executives "to take unnecessary and excessive risks that threaten the value of the financial institution"; (B) provision for recovery ("clawback") of incentive compensation paid to senior executive officers based on information that was materially inaccurate; and (C) a prohibition on making any golden parachute payment during periods when Treasury holds an equity position. The Act made clear that "Senior Executive Officer" was intended to be defined in the same manner as "named executive officer" is defined for purposes of disclosure under the Securities Exchange Act of 1934.

Section 302 of EESA also amended Section 162(m) of the Internal Revenue Code of 1986, which deals with "excessive remuneration" paid to an employee. New Section 162(m)(5), which was added by Section 302 of EESA, provides that, for employers from whom more than $300 million of troubled assets are acquired under the TARP, no deduction will be allowed for compensation exceeding $500,000 (contrasted with $1 million for other employers) paid in any year to the Chief Executive Officer, Chief Financial Officer or next three most highly compensated officers of the employer. In determining what "compensation" must be included in calculating whether the $500,000 threshold has been exceeded, new Section 162(m)(5) also eliminates the exclusions relied upon by most employers to pay commission based compensation and "performance-based compensation" under shareholder-approved plans without worrying about deductibility.

On October 20, 2008, Treasury issued an "Interim Final Rule" under Sections 111(b) and 302 of EESA clarifying these restrictions. Under the Interim Final Rule, as further clarified on January 16, 2008, Treasury made clear that both the Section 111(b) restrictions and the Section 302 restrictions apply to institutions that have sold preferred stock and warrants to Treasury under CPP, regardless of whether the institution has sold troubled assets to Treasury. Treasury adopted virtually identical guidance in its rules with respect to Systemically Significant Failing Institutions.

Each financial institution that obtained capital under CPP was required to do so under a "Securities Purchase Agreement Standard Terms" (the "Standard Terms"). The Standard Terms required the institution to agree that it would "take all necessary action to ensure that its Benefit Plans with respect to its Senior Executive Officers comply in all respects with Section 111(b) of EESA as implemented by any guidance or regulation thereunder that has been issued and is in effect as of the Closing Date" and "until such time as the [Treasury] ceases to own any debt or equity securities of the Company acquired pursuant to [the] Agreement or the warrant." For most institutions, this language means that the institution must comply with the Interim Final Rule issued by Treasury on October 20, 2008. Accordingly, institutions that receive CPP funds were required to amend their benefit plans to comply with the following four principal conditions, under Section 111(b), and to maintain that compliance so long as Treasury maintains a debt or equity position in the institution.

1. A prohibition on any "Golden Parachute Payment" to a Senior Executive Officer. Under the Interim Final Rule, a "Golden Parachute Payment" is (1) a payment to a Senior Executive Officer, (2) on account of "applicable severance," (2) that equals or exceeds three times the executive's "base amount." The base amount is computed as in Section 280G of the Internal Revenue Code for payments in connection with a change of control: the average aggregate taxable compensation to the executive for the five years ending with the calendar year prior to the transaction. Nevertheless, unlike an IRC Section 280G parachute payment, a Golden Parachute Payment includes any payment and does not need to arise from a change of control, but instead includes any involuntary termination, or any termination associated with the bankruptcy, insolvency or receivership of the institution.

2. A requirement that the Compensation Committee (or a committee acting in a similar capacity) review and discuss with senior risk officers for the institution within 90 days of its receipt of TARP funding, and annually thereafter, the relationship between the financial institution's risk management policies and Senior Executive Officer incentive compensation arrangements. The Committee is then required to certify that it has conducted this review "and has made reasonable efforts to ensure that such arrangements do not encourage the Senior Executive Officers to take unnecessary and excessive risks that threaten the value of the financial institution." For a public company, this certification is included in the Compensation Committee Report in the Company's proxy statement. For private companies, the certification is provided to the primary federal regulator. To further back up the certification, the January 2009 clarifying revisions to the Interim Final Rule require the principal executive officer of each institution that receives TARP funding to certify to the Chief Compliance Officer of TARP within 120 days of the receipt of TARP funds, and annually within 135 days of the end of each year, that this review and certification by the Compensation Committee has been completed. This clarifying revision was never published and has since been withdrawn in favor of regulations to be proposed to implement the requirements of ARRA.

3. A requirement that all incentive compensation paid to a senior executive officer be subject to recovery or "clawback" if it was based on materially inaccurate financial statements or any other materially inaccurate performance criteria The Rule makes clear that this provision is intentionally broader than Section 304 of the Sarbanes Oxley Act of 2002, which applies only to the chief executive officer and chief financial officer, and relates primarily to financial statement disclosure.

4. A requirement that the institution agree that any payment not complying with new Section 162(m)(5) will not be deductible—that annual compensation in excess of $500,000 to a Senior Executive Officer is not deductible by the corporation.

Anticipating ARRA, the Standard Terms included a provision that allow unilateral (and retroactive) amendments by Treasury "to the extent required to comply with any changes after the Signing Date in applicable federal statutes."

## B. Additional Treasury Restrictions

In response to Congressional concern that TARP funds were being misapplied, on February 4, 2009, Treasury announced additional guidance applicable to institutions that received governmental

assistance under TARP and related programs. These new guidelines distinguished between financial institutions that received funds under a "generally available capital access program," such as the CPP, and banks needing "exceptional assistance". Specifically included in the latter group were AIG, Bank of America, Citigroup and any other institution participating in the TIP, but specifically excluded CPP participants. For institutions in need of "exceptional assistance," Treasury's guidance is as follows:

1. Prohibits total compensation to Senior Executive Officers in excess of $500,000 per year, regardless of deductibility, other than in the form of restricted stock or other long-term incentive arrangements that vest after Treasury has been repaid;

2. Requires that Senior Executive Officer compensation be submitted to an annual non-binding shareholder vote ("say-on-pay");

3. Applies the claw-back provisions to not only Senior Executive Officers, but to the next 20 most senior executives if those executives knowingly engage in deceptive practices;

4. Expands the Golden Parachute prohibition on severance payments to include not only the Senior Executive Officers (the top five officers) but the top ten officers, and adds a prohibition on severance exceeding one year's compensation to the next 25 executives; and

5. Requires that companies adopt policies on luxury expenditures, including aviation services, office and facility renovations, entertainment and holiday parties, and conferences and events.

## C. ARRA

Before Treasury issued regulations implementing its new guidance, Congress trumped it with the ARRA (the "Stimulus Bill"). Although the original House bill did not contain provisions relating to executive compensation, when the Senate began debate on the bill during the week of February 9, 2009, it tacked on a new Title VII, containing a number of far reaching limitations on executive pay that applied retroactively to all recipients of government aide under the TARP. Although the Senate Bill that passed mid-week contained provisions that would have banned compensation to any employee of an institution that exceeded the pay to the United States President ($400,000), the conference committee smoothed some (although not necessarily all) of the rough edges in the bill relating to executive compensation. As included in ARRA, the new Title VII completely restates Section 111 of EESA, applies retroactively to "any entity that has received or will receive financial assistance provided under TARP," and directs the Secretary of Treasury to adopt standards that appear to mimic the "guidance" issued by Treasury for institutions receiving "exceptional assistance." These standards include, for TARP recipients and while TARP funds remain outstanding:

1. Review of incentive compensation payable to Senior Executive Officers to avoid excessive risk taking, and procedures for considering that compensation, that are virtually identical to those contained in EESA;

2. Extension of the claw-back provisions to not only Senior Executive Officers, but to the next 20 most highly-compensation employees (regardless of whether those employees knowingly engaged in deceptive practices);

3. Prohibition of any severance payment whatsoever to any senior executive officers or any of the five most highly compensated employees (other than for services performed and benefits accrued);

4. Prohibition on the payment, or accrual, of any incentive compensation whatsoever (unless pursuant to an existing contract and except for restricted stock that does not vest until the TARP funds are repaid and that does not exceed in value one-third of the total amount of annual compensation received by the employee) to an expanded group of executives based on the amount of TARP funds received. This prohibition applies to:

   a. the most highly compensated employee for institutions that receive less that $25 million in TARP funds;

   b. to the five most highly paid employees for institutions receiving $25 million or more, but less than $250 million of TARP funds;

   c. to the senior executive officers and ten next most highly compensated employees for institutions receiving $250 million or more, but less than $500 million of TARP funds; and

   d. to the senior executive officers and twenty next most highly compensated employees for institutions receiving $500 million or more in TARP funds;

5. Prohibition on compensation plans that encourage manipulation of earnings;

6. Certification of compliance similar to the requirement in EESA and Treasury Guidelines;

7. Compensation committee review of compensation plans semiannually;

8. A requirement for policies on luxury expenditures that mimic Treasury Guidelines for institutions that receive "exceptional assistance";

9. An annual, nonbinding shareholder vote on compensation (say-on-pay); and

10. Treasury review of compensation paid to Senior Executive Officers and the next 200 most highly paid employees prior to ARRA to determine whether the payments were inconsistent with the purposes of the TARP.

Importantly, Title VII of ARRA did explicitly eliminate the prohibition (except out of proceeds from "qualified financings") contained in the Standard Terms on repayment of TARP capital, allowing companies, subject to permission from their primary federal regulator, to simply pay it back if they wished to escape these limitations.

As of the date of this Report, Treasury had not issued rules, regulations or guidance under Title VII of ARRA. Although ARRA's deadline for SEC regulations on the say-on-pay requirement was not until a year after the Act was adopted, in a letter dated February 20, 2009 to Mary Shapiro, Chairman of the SEC, Senator Christopher Dodd (the author of Title VII), made clear that the say on pay provisions were effective immediately when the Act was adopted (February 17, 2009), and that the SEC should require all publicly-held TARP recipients to comply with its requirements. The SEC

confirmed that in a February 26, 2009, Compliance Disclosure Interpretation. To compound matters, the SEC made clear that the say-on-pay proposal was a matter that required filing of a preliminary proxy statement, tacking an additional ten days onto the proxy statement timetable, although the SEC did intimate that it would entertain requests to accelerate the ten day period.

The requirement for a say-on-pay proposal resulted in mildly panicked revision of proxy statements for calendar year companies attempting to grapple with this year's proxy season. Further, the additional delay occasioned by the requirement for a preliminary proxy statement filing, combined with confusion over the breadth of the ARRA compensation restrictions and the absence of any Treasury guidance, has prompted a number of TARP recipients to delay their annual meetings. Disclosure in proxy statements that have been filed simply state that, because Treasury guidance is unavailable, the filer is not able to fully describe ARRA's impact on 2009 compensation plans.

All TARP participants await additional guidance from Treasury on the timing and breadth of the restrictions on Executive Compensation contained in ARRA. Given the Interim Final Rule promulgated in response to EESA, however, we anticipate that this guidance will do little to provide relief from the far reaching limitations that ARRA places on executive compensation of institutions that have received, or will receive in the future, TARP funding.

## V. HOMEOWNER AFFORDABILITY AND STABILITY PLAN / MAKING HOME AFFORDABLE PROGRAMS

On March 4, 2009, the Obama Administration announced the Homeowner Affordability and Stability Plan (the "HAP") to support a recovery in the housing market by reducing home foreclosures and their destabilizing effects. It is intended to help individuals restructure or refinance their mortgages to avoid foreclosures and to strengthen confidence in Fannie Mae and Freddie Mac to support low mortgage rates.

### A. Making Home Affordable Program: Home Affordable Refinance Program

The first feature of HAP is the Home Affordable Refinance Program, which allows responsible home owners to refinance, where the credit crisis and falling home values would otherwise create obstacles to refinancing.

Home mortgage interest rates are at attractive levels right now, but many homeowners cannot refinance due to the fact that (a) the credit crisis has caused residential lenders to require increased equity, and (b) the equity these homeowners once enjoyed has evaporated due to the depressed residential market. Many lenders who once issued mortgage loans with a 100% loan-to-value ratio are now requiring 20% equity or more for a homeowner to take advantage of the low interest rates.

The Home Affordable Refinance Program is intended to allow 4 to 5 million responsible homeowners with current loans owned by Fannie Mae or Freddie Mac to refinance through these two institutions. The program is geared toward "responsible" homeowners; to be eligible, an individual must live in the residence as his or her primary residence and must be current on the existing mortgage. "Current", as used by the program, means the borrower has not been more than 30 days late on a mortgage payment in the last twelve months.

Other eligibility requirements are that (1) the amount owed is 105% or less than the value of the property; and (2) the borrower has stable income to support the new mortgage payments. The refinance program considers first mortgages only, but if a borrower is under water on its home due to a second mortgage, the borrower may still be eligible to refinance under this program.

HAP is for owner-occupied properties only, not speculators or flippers. The goal is to assist those who have been responsible with their home purchases and have stayed current on their mortgage loans by saving them money throughout the life of the loan, even though a borrower's current payment may not drop dramatically, particularly where a borrower had an interest-only loan. Outstanding principal amounts will not be adjusted under this program. Once a borrower is in arrears on mortgage payments, the borrower must look to the second feature of this program, the Home Affordable Modification Program.

### B. Making Home Affordable Program: Home Affordable Loan Modification Program

The Home Affordable Modification program is intended to implement the HAP by bringing together lenders, investors, servicers, borrowers, and the government to share in the cost of modifying mortgage loans to create affordable terms. Lenders, investors, servicers, and borrowers

may be eligible for financial incentive payments for loans successfully modified as part of the program. The program is also designed in part to encourage mortgage servicers, which may be hesitant to modify mortgage loans that they service for investors, to implement what the Obama Administration calls "common-sense" loan modifications that both reduce the chance of foreclosure and raise the value of the securities owned by investors. It will work in tandem with an expanded Hope for Homeowners program.

On March 4, 2009, Treasury announced guidelines (the "Guidelines") for the Home Affordable Modification program, which it hopes will set standard industry practice for loss mitigation protocols in the mortgage industry. The Guidelines are published online at: http://www.treas.gov/press/releases/reports/modification_program_guidelines.pdf.

All financial institutions receiving CAP funds must implement loan modification plans consistent with the Guidelines. Fannie Mae and Freddie Mac will use the Guidelines for loans that they own or guarantee. The Obama Administration will work with regulators and other federal and state agencies to implement the Guidelines across the entire mortgage market. Major mortgage insurance firms have also agreed to allow for partial claims on some modified loans.

- Summary of Loan Modification Guidelines

Successful completion of a trial modification period and entry into program agreements between a servicer and Treasury's financial agent are prerequisites for any payments to a lender, investor, servicer, or borrower under the Home Affordable Modification program. Trial loan modifications consistent with the Guidelines may be offered to homeowners beginning on March 4, 2009, and may be considered for acceptance into the Home Affordable Modification program upon completion of a trial period and other conditions. Servicers must enter into program agreements with Treasury's financial agent on or before December 31, 2009.

To be eligible for modification under the Home Affordable Modification program, a mortgage loan must have been originated on or before January 1, 2009, and must be a first-lien loan on a borrower-occupied property with an unpaid principal balance of not more than $729,750. Higher limits are allowed for properties with up to 4 units, provided the borrower occupies one of them. The borrower must document income and sign an affidavit of financial hardship. Modifications can start from now until December 31, 2012; mortgage loans can be modified only once under the program.

Servicers will use a net present value ("NPV") test on each mortgage loan that is at risk of imminent default or 60 days delinquent, comparing the NPV of cash flows with and without modification. If the NPV is greater with modification, then the servicer must modify the mortgage loan (absent fraud or a contractual prohibition that the servicer cannot get waived). The monthly payment is to be reduced to no more than 31% of gross monthly income by using a "standard waterfall" process, which includes first reducing the interest rate, subject to a rate floor of 2%; then extending the term if necessary; and then forbearing principal if necessary, with any forbearance being deferred to a balloon payment. Servicers must comply with any express pooling and servicing contractual restrictions for modifying current mortgage loans.

Lenders that service their own mortgage loans are considered "servicers" under the Guidelines.

- Incentive Compensation

Lenders, investors, servicers, and borrowers may be eligible for the following financial incentives for loans successfully modified as part of the Home Affordable Modification program:

- Treasury will share in the cost of reducing monthly payments.
- Servicers will receive an up-front fee of $1,000 for each eligible loan modification meeting the Guidelines. Servicers may also receive "pay for success" fees of up to $1,000 each year for three years, which shall be awarded monthly as long as the borrower stays current on payments on the modified loan.
- Homeowners who make their payments on time are eligible for up to $1,000 of "pay for performance" principal reduction payments each year for up to five years.
- If an at-risk mortgage loan is modified while the borrower is still current on payments, an additional incentive payment of $500 will be paid to the servicer and an incentive payment of $1,500 will be paid to the mortgage holder.
- There are additional incentives for efforts made to extinguish second liens on mortgage loans modified under this program, although specific dollar amounts are not included in the Guidelines.

To qualify for "pay for success" fees, the modification must reduce the monthly payment by at least 6%. No fees are to be charged to borrowers for loans modified under this program, and unpaid late fees are to be waived.

### C. Mortgage Cram Downs

The Obama Administration is supporting changes to the Bankruptcy Code that it believes will facilitate the goals of the Making Home Affordable programs. The proposed legislation will allow homeowners to file for bankruptcy under Chapter 13 of the Bankruptcy Code and implement a plan that modifies their mortgage after they have unsuccessfully tried to obtain affordable loan modifications from their lenders or servicers. This type of modification of a secured creditor's rights despite the creditor's objection is commonly referred to as "cramming down" a plan over the creditor's objection.

The controversial legislation introduced in the House and Senate gives bankruptcy judges the power to rewrite mortgages by lowering interest rates to reduce monthly mortgage payments. The proposed changes to the Bankruptcy Code require borrowers to prove that they tried to work with their lender or servicer to renegotiate payment terms before seeking help in bankruptcy court. Judges must also assess the debtor's good faith and consider whether the lender offered the homeowner a reasonable restructuring deal before rewriting the homeowner's mortgage terms. Under the proposed legislation, judges may also be allowed to reduce the outstanding principal balance of a primary residence home mortgage loan to current fair market value.

On March 5, 2009, the House passed its version of the bill which allows courts to rewrite the terms of only those mortgages originated prior to the date of the bill's enactment. The bill also specifically protects investors holding AAA-rated mortgage-backed securities from losses associated with cram downs and denies any proposed cram down if the debtor has been convicted of fraud. As of this writing, the Senate is currently debating similar legislation and is expected to vote on its bill in the weeks ahead.

### D. FHA, HOPE, and Local Community Programs

As part of the recovery plan, the Obama Administration is proposing legislation that will allow the FHA to reduce fees paid by borrowers, increase flexibility for lenders to refinance troubled loans, permit borrowers with higher debt loads to qualify, and address additional challenges that could limit the use of the Hope for Homeowners program. The Hope for Homeowners program was created under the EESA to help those at risk of default and foreclosure refinance into more affordable, suitable loans. It was recently expanded and improved to work in tandem with the Home Affordable Modification program.

The expanded Hope for Homeowners program offers an avenue for struggling borrowers to obtain a sustainable mortgage. Specifically, servicers are required to consider a borrower for refinancing into the Hope for Homeowners program when feasible, and incentives will be offered to servicers for refinancing borrowers into improved loans under the Hope for Homeowners program.

Importantly, consideration for a Hope for Homeowners refinance will not delay eligible borrowers from receiving a modification offer and beginning the trial modification period. If the underwriting process for a Hope for Homeowners refinancing will delay borrowers from receiving a modification offer, servicers must use the standard waterfall to begin the Home Affordability Modification and work to complete the refinancing during the trial modification period.

To strengthen communities hardest hit by the financial and housing crisis, the Department of Housing and Urban Development will award $2 billion in Neighborhood Stabilization Program grants for innovative programs that reduce foreclosure. The recovery plan also includes an additional $1.5 billion to provide renters' assistance, aimed at reducing homelessness.

### E. Strengthening Fannie & Freddie

Fannie Mae and Freddie Mac purchase the majority of residential mortgage loans originated in the United States. As we discussed in The Shape of the Bailout, Fannie and Freddie suffered a steady decline in their capital and market value last year. As a result, on September 7, 2008, the FHFA announced that it had placed both companies into conservatorship. The FHFA determined that a conservatorship was necessary to restore confidence in Fannie and Freddie and enable them to carry out their missions of providing liquidity to the mortgage market.

The most significant components of the conservatorship were three financing facilities provided by Treasury. These consisted of:

> (a) *GSE Credit Facility*. A short term debt facility administered by the Federal Reserve Bank of New York, through which the GSEs can borrow against the value of MBS that they issue.

(b) *GSE Securities Purchase Program*. A program under which Treasury, acting through independent asset managers, can purchase MBS issued by the GSEs, up to Treasury's statutory debt limit.

(c) *Senior Preferred Stock Purchase Agreement*. A capital maintenance program through which Treasury can make capital contributions to the GSEs whenever their total liabilities exceed assets, in exchange for senior preferred stock. Treasury committed up to $100 billion to each GSE under this program, the details of which are set out in stock purchase agreements. The GSEs will also be required to gradually reduce their MBS portfolios, starting in 2010.

As part of the HAP, Treasury intends to increase its funding commitment to the GSEs by increasing its preferred stock purchase agreements to $200 billion each from their original level of $100 billion each. The $200 billion increase in Treasury's GSE stock purchase funding commitments is being made under the Housing and Economic Recovery Act of 2008 and does not use money from the Financial Stability Plan or EESA. In addition, to promote stability and liquidity in the marketplace, Treasury will also continue to purchase GSEs' MBS and will increase the size of the GSEs' retained mortgage portfolios allowed under the agreements, by $50 billion to $900 billion, along with corresponding increases in the allowable debt outstanding.

### F. FDIC Loan Modification Program: "Mod in a Box"

The FDIC's loan modification program, dubbed "Mod in a Box", is another program to assist borrowers. "Mod in a Box" was initiated by the FDIC at IndyMac Federal Bank to address delinquent borrowers who occupy their homes. The FDIC has encouraged, and in connection with recent bank liquidations has required, other banks to use this program. The goal of the program is to rehabilitate distressed mortgages into performing loans while avoiding foreclosure. This is accomplished by reducing the borrower's payment by at least 10% and protecting the lender with a "net present value" test that requires the cost of the modification to be less than the estimated cost of foreclosure.

Details regarding this pre-packaged FDIC loan modification program can be found at: http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html .

"Mod in a Box" provides a streamlined approach to identify candidates for loan modification, but if a borrower does not qualify for the streamlined modification, a personalized modification may still be developed in order to maximize value.

Once eligibility is established, an "affordable" payment is calculated. "Affordable" is defined as a 31% to 38% housing payment to income ("HTI") ratio. If a 38% HTI ratio does not decrease the borrower's payment by at least 10%, the HTI ratio is lowered to 35% and then, if necessary, to 31% in order to achieve the 10% savings. The HTI ratio is not lowered below 31%, however, even if the 10% savings is not achieved. The affordable payment is then achieved by using a "three-step waterfall" process, which includes first reducing the interest rate, subject to a rate floor of 3%; then extending the term if necessary; and then forbearing principal if necessary, with any forbearance being deferred to a balloon payment.

"Mod in a Box" includes marketing materials and sample documentation that can be obtained at: http://www.fdic.gov/consumers/loans/loanmod/appendix.pdf

“Mod in a Box” has largely been superseded by the Home Affordable Loan Modification Program, which has somewhat different guidelines (more favorable to homeowners) and incentives. The section of the FDIC website for homeowners now links to FinancialStability.gov, which only refers to the Home Affordable Loan Modification Program. There is no reason, however, that a servicer or lender couldn't use “Mod in a Box” as a template for loans that don't qualify for the Home Affordable Loan Modification Program.

# VI. ODDS AND ENDS

## A. ARRA Tax Provisions

### 1. Elimination of 382 Loophole

A provision in ARRA revokes a recent Treasury Department ruling that granted tax benefits to the acquirers of troubled banks.

Section 382 of the Internal Revenue Code of 1986, as amended (the "Code"), generally limits the rate at which a corporation may use losses to offset income generated after an "ownership change." As defined in the Code, an ownership change can occur as a result of acquisitions, certain capital infusions, or other changes in corporate ownership structure, including tax-free reorganizations. Although the rules are somewhat complex, an ownership change typically occurs when the percentage of stock owned by one or more 5-percent shareholders of the loss corporation increases by more than 50 percent over a three-year period. Section 382 is intended to deter companies from acquiring businesses with loss carryovers and built-in losses in their assets in order to obtain the tax benefits associated with those losses.

In conjunction with bank bailout legislation and as part of efforts to encourage acquisitions of struggling banks, Treasury issued Notice 2008-83 on September 30, 2008. This Notice was intended to exempt financial institutions from some restrictions imposed on the utilization of losses under Section 382 following an acquisition, thereby making it easier for struggling banks to utilize, essentially without limitation, net operating loss carryovers and losses realized from loans on their books that have deteriorated in value.

ARRA revoked Notice 2008-83, stating that Treasury does not have the authority to provide exemptions from or special rules under Code Section 382 that are restricted to certain classes of taxpayers or particular industries. The revocation is effective for any ownership change that occurs after January 16, 2009, except for certain grandfathered transactions. Under these grandfather rules, Notice 2008-83 will continue to apply to transactions that result in an ownership change of a financial institution if those transactions occur pursuant to a binding written contract entered into on or before January 16, 2009, or were described in a public announcement or a Securities and Exchange Commission filing on or before that date.

ARRA also codified and broadened prior IRS efforts to exempt from the application of Code Section 382 acquisitions of equity or debt positions by Treasury in distressed financial institutions. Newly added Code Section 382(n) provides that the loss limitation rules will not apply in the case of an ownership change that occurs pursuant to a restructuring plan of a taxpayer required under a loan agreement or commitment for a line of credit entered into with Treasury under the EESA. Furthermore, the IRS published new Notice 2009-14 to clarify that the acquisition of stock in a loss corporation by Treasury pursuant to programs established under EESA and the redemption of such stock do not cause an ownership change for purposes of Section 382. This guidance also provides rules having similar effect with respect to the acquisition by Treasury of indebtedness and warrants, and to capital contributions by Treasury.

2. Tax Changes on Debt Modifications

The recent economic downturn has forced many taxpayers to restructure their debt. For distressed borrowers, the only alternative to bankruptcy is frequently to negotiate loan modifications. However, doing so can result in substantial tax liability because the gross income of a taxpayer includes income realized from the discharge of indebtedness. Discharge of indebtedness income can arise in a number of different situations, including not only cancellation of the debt but also modifications of the debt instrument, exchanges of the debt for stock or partnership interests, and other circumstances.

In an attempt to encourage borrowers and lenders to renegotiate loan terms, ARRA provides special rules intended to provide relief in certain cases from the immediate taxation of discharge of indebtedness income. These provisions do not alter the definition of discharge of indebtedness income, but rather permit debtors who are eligible under these special rules to elect to defer taxation of that income.

If an eligible taxpayer or a person related to the taxpayer reacquires or modifies the taxpayer's debt instrument after December 31, 2008 but before January 1, 2011 in a manner that gives rise to discharge of indebtedness income, the taxpayer can elect to pay tax on that income ratably over a period of five years starting in 2014. Under these rules, an eligible taxpayer includes a C corporation or any other business entity or individual that has issued a debt instrument for business purposes. The rules apply to "acquisitions" of the debt instrument, which term encompasses a variety of transactions, including a debt-for-debt exchange, acquisition of the debt instrument for cash, an exchange of the debt instrument for corporate stock or a partnership interest, the contribution of debt to capital and complete forgiveness of the debt.

## B. Federal Deposit Insurance Corporation Activities

In 2008, 25 FDIC insured institutions with total assets of $362 billion failed, and five other institutions were resolved in FDIC-assisted transactions. The pace has increased in 2009; as of this writing, 21 banks with total assets of about $9.5 billion, have failed, and there are over 250 institutions on the FDIC's "Problem List". The large number of troubled financial institutions has taxed the FDIC's resources, depleted the deposit insurance fund and necessitated new approaches to resolving troubled banks, with the FDIC increasingly assuming a share of losses to facilitate purchase transactions. The FDIC also appears to be exercising a high level of caution in approving deposit insurance applications for new banks.

1. Processing Accounts at Failed Institutions

Anticipating the current wave of bank failures, in July 2008 the FDIC issued an interim rule introducing new procedures for processing deposit accounts when it places a bank into receivership. A final rule was published on February 2, 2009. The rule permits the FDIC to establish a cut-off time for the purpose of calculating deposit insurance claims. The FDIC's cut-off time may be the same as the bank's standard cut-off time for processing deposit and withdrawal transactions, or it may be earlier. Late-day deposits to a closed bank will be returned to the account holder, while late withdrawals could be reclaimed by the FDIC.

A significant portion of the final rule deals with sweep accounts. Sweep arrangements are used for a variety of purposes: Many banks use "retail sweep" arrangements, where a single deposit account is divided into a transaction account and a money market deposit account, to reduce their reserve requirements; often customers are unaware of such arrangements. Commercial depositors may use consolidation or "zero balance" arrangements, where funds from various operating accounts or subsidiaries are swept daily to a parent account. Banks may also offer various investment sweep products, such as Eurodollar, repo or money market mutual fund sweeps, in which funds are moved from a depositor's transaction account to an investment vehicle, then returned according to a pre-arranged schedule. Under the final rule, a failed institution will process all pre-arranged internal sweeps on the closure date and will process those external sweeps that are scheduled to occur before the FDIC's cut-off time. The FDIC will insure funds in sweep accounts based on where the funds reside after the sweep. Thus, funds swept to a deposit account at the same institution, for example through a retail sweep on zero balance arrangement, would be insured up to the legal limit (currently $250,000 per depositor in most cases), while funds swept to a securities account or an offshore account would not be insured by the FDIC.

The rule requires that all financial institutions disclose to their sweep customers in writing whether swept funds are considered deposits for insurance purposes, and if they are not deposits, how they would be treated if the institution were to fail. The disclosures must be sent to all customers within 60 days after July 1, 2009, and at least annually thereafter, and must appear prominently in all new or renewed sweep contracts. The disclosure requirements do not apply to internal retail sweep or zero balance accounts, in which the sweep does not affect the depositor's insurance coverage.

2. The Deposit Insurance Fund

At the end of 2008, the deposit insurance fund reserve ratio (the ratio of FDIC reserves to insured deposits in all member institutions) had fallen to 0.4 percent, about one-third of the federally-mandated level of 1.15 percent. The FDIC's efforts to restore the fund have prompted significant debate in the industry, and in Congress. Last October, when the ratio first fell below the required level, the FDIC's board of directors published a plan of assessment increases to restore the reserves within five years. After continued deterioration, the FDIC has raised assessments again and extended the timeline for restoration to seven years. In the first quarter of 2009, banks in the lowest risk category will pay an assessment of 12 to 14 basis points. On April 1, 2009, the minimum assessment increased to 12 to 16 basis points. The FDIC proposed an emergency special assessment of an additional 20 basis points to be paid on September 30. This proposal was met with significant opposition from community banks, which felt that they were being asked to pay an unfair share of the costs to replenish the fund. Community banks receive some 85-95% of their funding from deposits, while large commercial banks receive only about half of their funding from deposits. Thus, community banks pay a proportionately larger share of FDIC premiums. The FDIC is considering alternatives to the special assessment, including raising assessments for the TLGP and imposing the special assessment based on total assets, not just insured deposits (so larger commercial banks would pay a larger share). In addition, a bill is currently before Congress that would increase the FDIC's ability to borrow from Treasury to meet the requirements of the current crisis.

3. Trends in Bank Resolutions

In 19 of the 21 bank closures this year, the FDIC was able to arrange purchase and assumption agreements for the sale of the failed institutions. The FDIC was unable to find a buyer for two institutions: MagnetBank of Salt Lake City, Utah; and First city Bank of Stockbridge, Georgia. In those two cases, the bank's deposits, nearly all of which were insured, were paid to customers, and the bank's assets were placed in receivership.

The FDIC has increasingly been using loss-sharing agreements to facilitate takeovers of failed institutions as "whole banks," in which the purchaser acquires all or substantially all of the failed bank's assets. Two such transactions occurred in December 2008 and at least five have been arranged so far this year. In a loss-sharing agreement, the FDIC typically agrees to reimburse the purchaser for 80-95% of its losses on the failed bank's assets during the first several years after the acquisition, in return for a like share of any later recoveries on those assets. For example, in the recent purchase of Alliance Bank by California Bank and Trust, the FDIC agreed to assume 80% of the first $275 million of losses and 95% of the rest (on assets of $1.12 billion).

Nearly all of the other transactions in the last six months have been deposit purchases, in which the purchaser acquires only the failed bank's deposits (sometimes only insured deposits) and loans secured by those deposits. In those cases the FDIC must manage the failed bank's other assets until it can liquidate them. In contrast, the FDIC views loss-sharing transactions as beneficial because they keep such assets under private management and reduce the FDIC's administrative burden.

On March 20, 2009, the FDIC announced that it had completed the sale of IndyMac Bank to a group of private investors. The FDIC had been operating IndyMac in receivership since July, 2008. The purchase agreement includes loss sharing provisions and requires IndyMac to continue the "mod in a box" program that the FDIC pioneered there (discussed in more detail in Section V. F. of this report).

We reported in The Bailout Revisited that the OCC and FDIC had begun issuing shelf charters to private investors for the purpose of bidding on failed banks. As of this writing, it does not appear that any private investor group chartered by the OCC has successfully bid on a closed bank, but the group that purchased IndyMac received similar pre-clearance from the OTS.

4. Chartering New Institutions

Industry reports suggest that the FDIC has imposed an unofficial moratorium on deposit insurance applications for start-up banks in those states hardest hit by the mortgage loan crisis (Arizona, California, Florida, Georgia, Nevada and perhaps others). Groups looking to form new banks in those states have had their insurance applications denied, even after satisfying initial capital requirements and obtaining approvals from other regulators. Such a moratorium could serve to reduce competitive pressures in areas where there are already a large number of troubled banks. The FDIC denies that any such moratorium is in place, but according to its own data, it rejected 33% of applications received in 2008, up from 20-21% in the two previous years, and the number of new banks chartered in the fourth

quarter of 2008 was the lowest in 12 years.

### C. Federal Reserve Initiatives

The response to the financial turmoil of the last 18 months has exhausted the Federal Reserve Board's traditional tools for managing the economy. It has also doubled the volume of assets on the Fed's balance sheet, as it devises new ways to pump liquidity into the financial markets.

The Fed effectively exhausted its primary tool for stimulating market activity when it cut the target Federal Funds Rate (the rate at which banks lend federal reserve balances to each other in overnight transactions) to a range of 0 to 25 basis points on December 16, 2008. The Federal Open Market Committee has indicated that rates are likely to remain at or near historic lows for some time.

Having failed to revive the financial markets through interest rate cuts, the Fed has expanded the use of its other traditional tool, the discount window, and developed several new lending facilities. Since August 2007, the Fed has lowered the spread between the Federal Funds Rate and the Discount Rate (the rate at which banks and other eligible institutions can borrow directly from the Fed) from 100 basis points to 25 basis points for well-capitalized institutions, increased the term of discount window loans from overnight to 90 days, and opened the discount window to primary government securities dealers. The Fed has also approved bilateral currency swap agreements with 14 central banks in Europe, Asia and Central America, to make more dollars available in foreign markets.

In addition to these efforts, the Fed has moved beyond its traditional role as a lender of last resort for member banks and become engaged directly in financial markets by creating several new lending facilities, including the TALF discussed in Section III C. above. Legal authority for these programs can be found in Section 13(3) of the Federal Reserve Act, which permits the Federal Reserve Board in "unusual and exigent circumstances" to purchase discounted debt from individuals, partnerships and corporations that are unable to obtain credit from other banking institutions:

- Commercial Paper Funding Facility ("CPFF"). This facility, administered by the Federal Reserve Bank of New York, provides a backstop to U.S. issuers of commercial paper through a specially-created limited liability company. The LLC purchases three-month unsecured and asset-backed commercial paper directly from eligible issuers, using funds borrowed from the Fed; in return, the Fed gets a security interest in the LLC's assets and earns fees from the issuers. As of March 18, 2009, the net book-value of commercial paper in the CPFF was $238,190,000,000, or about 16% of U.S. commercial paper outstanding.

- Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF"). This facility was created in September 2008, after a large mutual fund, the Reserve Fund, "broke the buck," leading to a rapid sell-off in money market mutual funds. The Federal Reserve Bank of Boston makes loans to depository institutions and bank holding companies to buy commercial paper from money market mutual funds so that the funds can meet investors' demands for redemptions. As of March 18, 2009, the outstanding principal balance of loans under AMLF was $7,634,000,000.

- Money Market Investor Funding Facility ("MMIFF"). The Federal Reserve created this facility to provide an additional source of liquidity to money market mutual funds, this

time through loans to LLCs which can purchase eligible assets directly from funds and from certain other investors that operate in a manner similar to money market mutual funds, such as local government investment pools, common trust funds and collective investment funds. To date, there has been no borrowing under the MMIFF.

In addition to these lending facilities, the Federal Reserve announced in November 2008 that it would purchase up to $100 billion in debt issued by Fannie Mae and Freddie Mac, and that it would purchase up to $500 billion in GSE-issued mortgage-backed securities, in an effort to revitalize the mortgage lending industry. On March 18, 2009, the Federal Reserve expanded this program, announcing it would increase its purchase of GSE-issued mortgage-backed securities to $1.25 trillion, and that it would purchase up to $300 billion in long-term Treasury securities.

These efforts have had the effect of more than doubling the assets on the Fed's balance sheet from an average of around $900 billion during the year to August 2008, to approximately $1.9 trillion today. Many of these assets are short-term loans that can be allowed to run off when the economy improves but some, like the mortgage-backed securities, GSE debt and TALF loans, could remain in government hands for years to come. The Fed's Section 13(3) authority for these special programs will terminate once market conditions stabilize, so it will be required by law to unwind all of its extraordinary actions.

The Fed's actions have also led some to express concern that its market activities will undermine its ability to manage monetary policy. The Fed and Treasury issued a joint statement on March 23, 2009 to "clarify" the Fed's role. The carefully-worded statement indicates, among other things, that the Fed will aim to improve financial conditions broadly, not to allocate credit to narrowly-defined sectors, and that it will attempt to liquidate some of the special assets on its books, such as facilities created to support JPMorgan's purchase of Bear Stearns, at an early date.

Finally, the Fed has urged bank holding companies, especially those receiving federal assistance, to not pay or to drastically reduce their dividends. In a February 24, 2009 letter, the Fed warned bank holding companies under its supervision that paying dividends in the current environment could result in a finding that the organization is operating in an unsafe and unsound manner. The letter also encouraged bank holding companies to improve the quality of their bank capital by issuing common and (to a lesser extent) preferred stock, rather than hybrid securities, such as trust-preferred stock, which are treated as equity for regulatory purposes and debt for tax purposes. Many of the nation's largest banks have substantially reduced or eliminated dividends in recent weeks.

## VII. WHAT'S NEXT

### A. "Resolution Authority"

A debate is currently raging over whether to nationalize the weakest or most obviously insolvent financial firms. The term "nationalize" has a distinctly un-American connotation, bringing to mind government seizures of profitable businesses in socialist or communist countries. Nevertheless, the U.S. banking system already has in place a regulatory scheme under which insolvent or significantly undercapitalized banks, savings institutions and credit unions (referred to in this section generically as "banks") are taken over by the Federal government.

A failed bank may be seized by the FDIC (or the NCUA, in the case of a credit union). When the responsible federal or state banking agency makes a determination that is bank is insolvent-- i.e., the value of a bank's assets are lower than its liabilities, or a bank's liquidity is insufficient to meet financial obligations to depositors or creditors, or a bank's equity capital has dropped to the point that its failure is imminent -- the FDIC will generally be appointed receiver of the insolvent bank. In most cases, the receiver will transfer the bank's insured deposits (and, in many cases, uninsured deposits) to a solvent financial institution, less any payments made by the acquiring institution for the value of the failed bank's good assets, core deposits and franchise value. Typically, the banking offices of the failed bank reopen (typically after a weekend) as branches of the acquiring financial institution. The FDIC then winds up the failed bank's remaining assets and pays the secured and unsecured creditors and shareholders of the failed bank under a liquidation priority regime comparable to that applicable to bankrupt corporations. In a few cases, the FDIC will simply pay off the insured deposits, liquidate the failed bank's assets, and make payments to creditors (including itself, to the extent it has paid insured depositors, and uninsured depositors) in accordance with their legal rights.

The current problem facing the financial system is that there are a number of banking institutions, such as Citigroup and Bank of America, which are deemed by Treasury to be too large to be placed into a traditional bank receivership. FDIC Chairman Sheila Bair has stated publicly that her agency lacks the resources to resolve a large financial conglomerate. These institutions own financial services businesses, from investment banking to securities brokerage, insurance, specialty finance, structured products and so on, which are carried out by non-banking affiliates organized or formed in under the laws of various states and or foreign countries.

AIG is another example of the new financial supermarket. It is primarily an insurance holding company, and operates dozens of regulated insurance companies around the world. Those insurance companies are individually regulated by the states and nations in which they were formed. AIG also operates a savings institution that has a primary federal banking regulator, in this case the OTS, and it owns some non-regulated businesses, including the London-based financial products affiliate. No single regulatory authority has overall supervisory responsibility for AIG. Trading on the capital or credit ratings of affiliated banks and insurance companies, AIG's non-regulated subsidiaries exposed the parent corporation to billions of dollars of potential liabilities. The banking regulator (in the case of AIG, OTS) could certainly have placed the bank into receivership if it were insolvent, and the individual insurance company regulators could have done the same for the insurance subsidiaries. But AIG's unregulated subsidiaries are subject to national bankruptcy regimes outside of the regulatory framework.

A related problem is that there are very few, if any, banking organizations which have sufficient excess capital to absorb the assets and liabilities of these financial supermarkets. The U.S. Government, acting through Treasury and the Federal Reserve, is generally regarded as the only player with access to the funding required to recapitalize these huge institutions. Treasury, the Federal Reserve and the Obama Administration are attempting to design an approach that will not require the U.S. government to step in and assume the entire financial and operational burden of stabilizing and ultimately liquidating these institutions.

The TARP program to date has not provided enough capital to stabilize Citigroup or AIG, and may not have provided enough capital to stabilize Bank of America. The government owns roughly 80% of AIG, and the Federal Reserve has made tens of billions in loans to AIG. The recent conversion of the government's preferred stock in Citigroup to common equity, and additional common equity injections, are tantamount to nationalization in all but name. But Treasury and the Federal Reserve arguably do not have the tools that a bankruptcy trustee or receiver would have to reorganize or wind up institutions. Public acknowledgment of the insolvency of some of these large financial institutions may be unavoidable once the Stress Tests undertaken by Treasury as part of the FSP are complete, although CAP provides for a capital cushion of up to 2% of assets and the possibility of further assistance.

The Obama Administration intends to ask Congress to give Treasury and the Federal Reserve unprecedented powers to resolve non-bank financial companies, such as bank holding companies, and their non-banking affiliates, large insurers, investment firms and hedge funds, whose collapse would (in the opinion of Treasury and the Federal Reserve) damage the broader economy. The Obama Administration's position is based on two assumptions: first, that non-bank financial market participants are potential sources of systemic market risk; and, second, that the organizational complexity of some non-bank financial market participants, such as AIG, make the use of traditional insolvency and bankruptcy procedures to reorganize and reshape those institutions risky and inappropriate. Thus, for example, it is argued by the Obama Administration that the legal and financial structures of certain financial supermarkets, their positions vis-à-vis counterparties and the volatile values of their assets (such as, for example, derivatives contracts) create problems for bankruptcy administrators, who would be forced to act in a rapidly changing environment and in multiple regulatory jurisdictions.

Moreover, bankruptcy administrators cannot take into consideration the effect of financial institution insolvency on third parties, such as counterparties to derivative contracts that have exceedingly complex and substantial financial entanglements with the failed institution. This inability of bankruptcy administrators to consider the interests of such non-bankrupt parties in connection with the typical bankruptcy proceeding can have an adverse impact on a broad group of stakeholders beyond those stakeholders that are engaged in the proceeding.

The question of who would oversee non-bank financial institutions is unclear, however. Treasury Secretary Geithner and Federal Reserve Chairman Ben Bernanke, in a rare joint appearance before a House Committee, said the messy federal intervention into AIG demonstrated a need to regulate complex non-bank financial institutions just as banks are now regulated by the FDIC, but the two appeared somewhat divided over where the authority should reside. Geithner suggested that Treasury's powers be expanded. Bernanke was noncommittal, even suggesting the FDIC might perform the role. Bernanke indicated that giving the Secretary authority over a broader range of companies would mark a very significant shift from the traditional model of financial regulation, which relies on independent agencies that are shielded from the political process. Under the Obama

Administration's proposal, the Secretary, a member of the president's Cabinet, would exercise the new powers in consultation with the White House, the Federal Reserve and other regulators.

## B. Other Regulatory Initiatives

### 1. Hedge Funds and Private Equity Funds.

On March 26, 2009, the Secretary outlined a framework for regulatory reform that, among other measures, would require certain hedge funds and other private investment funds to register with the Securities and Exchange Commission. In his proposal relating to hedge funds and other private capital pools, Geithner said that reliable, comprehensive information is required to assess whether the funds, either individually or as a whole, pose a systemic threat. He noted that the Madoff fraud demonstrated that gaps in the regulation and enforcement of broker-dealers, investment advisers, and the funds they manage must be closed.

The new framework would require:

- all advisers to hedge funds and other private pools of capital—including private equity funds and venture capital funds—whose assets under management exceed a certain threshold to register with the SEC;
- all funds advised by an SEC-registered investment adviser to be subject to investor and counterparty disclosure and reporting requirements;
- funds to disclose, on a confidential basis, information necessary to determine whether their size or leverage would pose a systemic threat; and
- the SEC to share the information it received with the systemic risk regulator, which would then determine whether the funds should be subject to prudential standards.

Douglas Lowenstein, president of the Private Equity Council, warned that the proposed framework "would impose potentially significant regulation on the private equity industry." Lowenstein stressed that private equity investments do not create systemic risk. "Private equity firms invest in companies, not exotic securities, and their investors are long-term investors, eliminating the 'run on the bank' type of risk that helped create the current financial crisis." Lowenstein said the council will work with the Obama Administration and Congress to ensure that any legislation enacted will benefit the economy "without imposing undue burdens on private equity firms seeking to make investments that create jobs and make companies more competitive."

### 2. Money Market Funds.

On March 26, 2009, Treasury urged the SEC to strengthen regulations around money market funds to reduce risks on individual funds and make the industry less susceptible to "runs" by investors. This action was prompted by last year's incident in which The Reserve Fund "broke the buck" – fell below par value -- prompting Treasury to provide a temporary guarantee program. Treasury said the SEC should "strengthen" the funds' regulatory framework. Geithner argued, for example, that after the fall of Lehman Brother's holding

company, regulators learned that even money market funds ─ "the most stable and least risky investment vehicles" ─ were vulnerable to failures of systemically important companies. The withdrawals, which were prompted by the failure of The Reserve Fund following Lehman Brothers' bankruptcy, "resulted in severe liquidity pressures, not only on prime money market funds but also on financial and non-financial companies that relied significantly on money market funds for funds," Geithner said. "The vulnerability of money market funds to breaking the buck and the susceptibility of the entire prime money market fund industry to sharp withdrawals in such circumstances remains a significant source of systemic risk."

The SEC is already looking at the money market fund issue. SEC Chairman Mary Schapiro, in her March 26, 2009, written testimony before the Senate Banking Committee, said that "a particular focus" of the commission "in coming weeks" will be proposals to enhance money market mutual funds standards. Schapiro said that the SEC will strengthen the regulation of the market by considering ways to improve the funds' credit quality, maturity, and liquidity standards. "These efforts will be aimed at shoring up money market fund investments and mitigating the risk of a fund experiencing a decline in its normally constant $1.00 net asset value." The SEC's reform will center on changes to 1940 Investment Company Act Rule 2a-7, under which money funds are regulated. The rule contains risk-limiting provisions intended to help a fund achieve a stable net asset value.

The mutual fund industry has been mulling the same changes proposed by SEC Chairman Schapiro. Paul Schott Stevens, the president and CEO of the Investment Company Institute, the national association for mutual funds, pointed out that on March 18, 2009, ICI called for new regulatory and oversight standards for money funds, including mandating new minimum liquidity standards, tightening portfolio maturity limits, and raising credit quality standards. "[W]e look forward to working with regulators and policymakers as they consider how to move forward," he said in an e-mail. "In the meantime, the industry is moving ahead with voluntary implementation of the new standards recommended by ICI."

3. Derivatives.

Clarity and more oversight were recommended by the Obama Administration for over-the-counter derivatives. The Secretary proposed that, for the first time, the government regulate the market for over-the-counter derivatives, including credit default swaps. "We will subject all dealers in OTC derivative markets and any other firms whose activities in those markets pose a systemic threat to a strong regulatory and supervisory regime as systemically important firms," he said. Specifically, the Secretary said his proposal would:

- require all "standardized" OTC derivative contracts to be cleared through "appropriately designed" counterparties;
- "encourage" greater use of exchange-traded instruments;
- subject the central counterparties to "comprehensive settlement systems supervision and oversight";
- require that all non-standardized derivatives be reported to "trade repositories" and subject to "robust" standards for documentation and confirmation of trades, netting, collateral and margin practices, and close-out practices;

- require central counterparties and trade repositories to make aggregate data on trade volumes and positions publicly available;
- require individual counterparty trade and position data to be made available on a confidential basis to federal regulators; and
- strengthen participant eligibility requirements, introduce disclosure and suitability requirements, and add recordkeeping and reporting requirements.