



Regulated Financial Institutions Alert

Developments in financial institutions law

A publication of Nixon Peabody LLP

FEBRUARY 18, 2009

Department of Treasury announces financial stability plan

By Lloyd Spencer

On January 10, 2009, Timothy Geithner, Secretary of the Department of Treasury, announced the new administration's Financial Stability Plan. Noting that our nation faces the most severe financial crisis since the Great Depression, Mr. Geithner believes that this is a crisis of confidence, of capital, of credit, and of consumer and business demand. The Financial Stability Plan is intended to be a comprehensive approach to strengthening the financial system, designed to attack the credit crisis on all fronts with the government's full arsenal of financial tools and resources.

With the new plan, the Obama administration has decided to fundamentally reshape the government's program to repair the financial system. While there are still more details forthcoming, the Financial Stability Plan contains the following six parts:

- Financial Stability Trust
- Public-Private Investment Fund
- Consumer and Business Lending Initiative
- Transparency and Accountability Agenda
- Affordable Housing Support and Foreclosure Prevention Plan
- Small Business and Community Lending Initiative

Financial Stability Trust

The Department of Treasury is calling for a supervisory review of the balance sheets of financial institutions and a comprehensive stress test to determine the ability of financial institutions to weather a continued decline in the economy. The supervisory review will involve the federal banking agencies working in a coordinated way to bring more consistent, realistic, and forward-looking assessment of exposures on the balance sheets of financial institutions. The comprehensive stress test will involve an assessment of whether major financial institutions have the capital necessary to continue lending and to absorb the losses that could result from a more severe decline in the economy than is currently projected.

The Financial Stability Plan will include a Capital Assistance Program (CAP) that is intended to serve as a bridge to raising private capital. The CAP will provide a “capital buffer” to ensure firms have the capital strength to preserve or increase lending in a worse-than-expected economic downturn. Under the CAP, firms will issue to Treasury a preferred security investment that can be converted into common equity if needed to preserve lending in a worse-than-expected economic environment. This convertible preferred security will carry a dividend to be specified later and a conversion price set at a modest discount from the prevailing level of the institution’s stock price as of February 9, 2009.

All banking institutions with assets in excess of \$100 billion will be required to participate in the coordinated supervisory review process and comprehensive stress test. Banking institutions with consolidated assets below \$100 billion will be eligible to obtain capital from the CAP after a supervisory review.

Any capital investments made by Treasury under the CAP will be placed in the Financial Stability Trust, a new entity that will be set up to manage the government’s investments in financial institutions.

Public-Private Investment Fund

Treasury, together with the FDIC and the Federal Reserve, will initiate a Public-Private Investment Fund that intends to take a new approach to cleaning up the balance sheets of financial institutions. This new program will use public financing to leverage private capital on an initial scale of up to \$500 billion, with the potential to expand up to \$1 trillion. The program is designed to bring private sector equity capital contributions to make large-scale asset purchases, and will allow private sector buyers to determine the price for current troubled and previously illiquid assets.

Consumer and Business Lending Initiative

As a result of the significant decline in securitized lending in the small business, commercial real estate, and auto loan markets, Treasury is developing a Consumer and Business Lending Initiative. The inability of financial institutions to sell these loans into secondary markets has adversely affected the availability of credit for these borrowers.

This joint initiative with the Federal Reserve will build off, broaden, and expand the resources of the previously announced but not-yet-implemented Term Asset-backed Securities Loan Facility (TALF). This initiative will support the purchase of loans by providing financing to private investors to help unfreeze and lower interest rates for auto, small business, credit card, and other consumer and business credit. However, purchases will be limited to newly packaged AAA-rated loans. In addition, this initiative will expand the TALF to include commercial mortgage-backed securities.

Transparency and accountability agenda

In response to media reports regarding the use of money under the Troubled Asset Relief Program (TARP), the Financial Stability Plan calls for greater transparency, accountability, and conditionality, with tougher standards for firms receiving exceptional assistance. These new standards will not be applied retroactively to firms that have previously received government assistance. The new standards are summarized below.

Reporting expansion of lending. Recipients of exceptional assistance or capital buffer assistance will be required to show how every dollar of capital they receive is enabling them to preserve or generate new lending, compared to what would have been possible without government capital assistance. Every recipient of assistance must submit a plan for how they intend to use that capital to preserve and strengthen their lending capacity. This plan must be submitted during the application process, and Treasury will make these reports public upon completion of the capital investment in the firm.

Financial institutions must provide monthly reports to Treasury detailing their lending, broken out by category, showing how many new loans they provided to businesses and consumers and how many asset-backed and mortgage-backed securities they purchased, accompanied by a description of the lending environment in the communities and markets they serve. Such a report will also include a comparison to their estimate of what their lending would have been in the absence of government support. For public companies, similar reports will be filed on a Form 8-K simultaneous with the filing of Form 10-Q or Form 10-K reports.

Mortgage foreclosure mitigation. All recipients of capital investments under the new Financial Stability Plan will be required to commit to participate in mortgage foreclosure mitigation programs consistent with guidelines to be issued by Treasury.

Restriction on dividends, stock repurchases, and acquisitions. Until the government investment is repaid, all banks that receive new capital assistance will be restricted from:

- paying dividends on common stock in excess of \$0.01 per share;
- repurchasing shares, subject to approval by Treasury and their primary federal regulator; and
- pursuing acquisitions of healthy firms.

Executive compensation limits

Firms will be required to comply with the senior executive compensation restrictions that were announced on February 4, 2009, by Treasury. These restrictions include a \$500,000 total annual compensation cap plus restricted stock, “say on pay” shareholder votes, and new disclosure and accountability requirements applicable to luxury expenses.

Since the announcement of the Financial Stability Plan, the American Recovery and Reinvestment Act of 2009 was signed into law by President Obama. This act substantially amends the executive compensation provisions of the Emergency Economic Stabilization Act of 2008 and is applicable to all financial institutions, including those that received capital assistance before passage of the act. However, there are certain inconsistencies between the provisions of the Act and Treasury’s February 4 guidance.

Affordable housing support and foreclosure prevention plan

Treasury stated that it will be announcing a comprehensive plan aimed at ending the foreclosure crisis. As part of this plan, Treasury and the Federal Reserve will commit to expanding the current effort by the Federal Reserve to help drive down mortgage rates through continuation of its efforts to spend as much as \$600 billion for purchasing GSE mortgage-backed securities and GSE debt. The

plan will also commit \$50 billion to preventing avoidable foreclosure of owner-occupied middle-class homes by helping to reduce monthly payments, in line with prudent underwriting and long-term performance. In addition, the plan will establish loan modification guidelines and standards for government and private programs and require all Financial Stability Plan recipients to participate in the foreclosure mitigation plans.

Small Business and Community Lending Initiative

Treasury stated that the Obama administration and the Small Business Administration (SBA) will announce the launch of a Small Business and Community Bank Lending Initiative in an effort to reverse the decline in SBA lending. Under this initiative, the government will (i) finance the purchase of AAA-rated SBA loans to unfreeze secondary markets for small business loans; (ii) increase the guarantee of SBA loans from as low as 75 percent to as high as 90 percent; and (iii) reduce fees for SBA 7(a) and 504 lending, and provide funds for speedier and less-burdensome processing of loan applications.

For further information, contact your Nixon Peabody attorney or:

- in our Rochester office, Bruce Baker, 585-263-1232;
- in our San Francisco office, Steven Plevin, 415-984-8462; or
- in our Washington, D.C., office, Lloyd Spencer, 202-585-8303 or Raymond Gustini, 202-585-8725.