Financial Institutions

E-ALERT

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Obama Administration Unveils Financial Stability Plan

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On February 10, 2009, Secretary of the Treasury Timothy Geithner held a press conference to unveil the Obama Administration's comprehensive plan to address instability in the banking sector, shortages in consumer and business lending, increased transparency in government funding programs, affordable housing initiatives, and small business lending. Shortly thereafter, the Department of the Treasury released a fact sheet detailing the Administration's new "Financial Stability Plan." The fact sheet does not contain extensive details on many elements of the Plan. The Administration will continue to develop and announce many of the Plan's details as we move forward.

The following is an overview of the key elements of the Financial Stability Plan:

1. **Financial Stability Trust.** This element will involve Treasury's direct investment in financial institutions.

   - Coordinated Supervisory Review Process. Treasury will work with the federal bank supervisors and the Securities and Exchange Commission to improve public disclosure by banks, including measures to improve the disclosure of exposures on bank balance sheets. All relevant financial regulators -- the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision -- will work in a coordinated way to bring more consistent, realistic, and forward-looking assessment of exposures on institutions' balance sheets.

   - Comprehensive Stress Test. All banking institutions with assets in excess of $100 billion that seek to participate in the Capital Assistance Program, discussed below, will be required to undergo a forward-looking "stress test" to determine whether the institution has the capital necessary to continue lending and to absorb the potential losses that could result from a more severe decline in the economy than projected.

   - Capital Assistance Program (CAP). Financial institutions that have undergone a stress test will have access to a Treasury-provided "capital buffer" to absorb losses and to serve as a bridge to receiving increased private capital. The capital buffer will operate as a form of "contingent equity" to ensure that institutions have the capital strength to preserve or increase lending in a worse-than-expected economic downturn. Institutions that access Treasury's "capital buffer" will receive a preferred security investment from Treasury in the form of convertible securities that they can convert into common equity if needed to preserve lending in a worse-than-expected economic environment. The convertible preferred 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." Banking institutions with consolidated assets below $100 million will also be eligible to obtain capital from the CAP after a "supervisory review."

   - Financial Stability Trust. Capital investments made by Treasury under the CAP will be placed in a separate entity called the "Financial Stability

Trust". The Trust will be set up specifically to manage the government's investments in U.S. financial institutions.

2. **Public-Private Investment Fund.** This element will involve the creation of a fund to purchase financial institutions' troubled assets.

   - Public-Private Capital. The fund will have a public-private financing component and could involve putting public or private capital side-by-side and using public financing to leverage private capital on an initial scale of up to $500 billion, with possible expansion up to $1 trillion.

   - Private Sector Pricing of Assets. The new program is designed to bring private sector equity contributions to make large-scale asset purchases, and thereby allow private sector buyers to determine the price for troubled and previously illiquid assets. Treasury's fact sheet does not provide any further detail on pricing mechanisms.

3. **Consumer and Business Lending Initiative**. This element is intended to unfreeze the market for consumer and business loan securitizations.

   - Expansion of the Term Asset-Backed Securities Loan Facility. The Term Asset-Backed Securities Loan Facility (TALF) is a joint initiative between Treasury and the Federal Reserve under which companies can receive loans to purchase eligible, newly packaged asset-backed securities backed by eligible collateral, including currently certain auto, small business, and credit card loans. Previously, the maximum amount of funds to be lent under the TALF was $200 billion. According to Treasury, that lending figure will now be increased to up to $1 trillion. Also, Treasury and the Federal Reserve have indicated that they intend to expand eligible collateral for purposes of the TALF to include commercial mortgage-backed securities and possibly other asset classes, such as non-Agency residential mortgage-backed securities and assets collateralized by corporate debt.

   - Limitation to AAA Loans. To be eligible for TALF loans, asset-backed securities must have a credit rating of AAA.

4. **Transparency, Accountability, and Monitoring Measures**. This element is intended to improve accountability and transparency in the Financial Stability Plan. According to Treasury, these new standards will apply "going forward and are not retroactive."

   - Assistance Must be Tied to Increased Lending. Recipients of both "exceptional assistance" and "capital buffer" assistance will be required to submit a plan for how they intend to use the capital to preserve and strengthen their lending capacity. This plan will be submitted during the application process. Institutions will also be required to detail in monthly reports submitted to Treasury their lending broken down by category, showing how many new loans they provided to businesses and consumers and how many asset-backed and mortgage-backed securities the institution purchased. This monthly report must also include a description of the lending environment in the institution's communities and markets. The report will include as well a comparison to the most rigorous estimate of what the institution's lending would have been in the absence of government support. Public companies will be required to file similar reports on a Form 8-K simultaneous with the filing of their 10-Q or 10-K reports. All information disclosed or reported to Treasury by recipients of capital assistance will be posted on the www.financialstability.gov website.

   - Commitments to Mortgage Foreclosure Mitigation. Recipients of capital investments by the government will be required to commit to participate in mortgage foreclosure mitigation programs consistent with guidelines Treasury will release on industry standard best practices.

- Restrictions on Dividends, Stock Repurchases, and Certain Acquisitions. Institutions that receive “exceptional assistance” will be restricted to paying quarterly common dividend payments of only $0.01 per share until the government investment is repaid. The same will also be true for institutions receiving generally available “capital buffer” assistance, unless Treasury and the institution’s primary regulator approve a higher amount based on their assessment that it is consistent with the bank’s capital planning objectives. Institutions receiving funding will also be restricted from repurchasing any privately-held shares, subject to approval by Treasury and their primary regulator, until the government’s investment is repaid. Finally, all institutions receiving funding will be restricted from pursuing cash acquisitions of healthy firms until the government investment is repaid, although exceptions will be made for explicit supervisor-approved restructuring plans.

- Limitations on Executive Compensation. Institutions receiving assistance under the new initiative will be required to comply with the senior executive compensation restrictions announced on February 4, 2009.[1] These restrictions include the $500,000 cap on total annual compensation (plus certain restricted stock) for senior executives, “say on pay” shareholder votes, and new disclosure and accountability requirements applicable to luxury purchases.

- Prohibitions on Political Interference. Treasury recently announced measures to ensure that lobbyists do not influence applications for, or disbursements of, Financial Stability Plan funds. Treasury will certify that each investment decision is based only on investment criteria and the facts of the case.

- Investment Transparency. All contracts under the Financial Stability Plan will be posted to the www.financialstability.gov website within five to ten business days of their completion. For each capital investment made under the new initiative, Treasury will make public the value of the investment, the quantity and strike price of warrants received, and the schedule of required payments to the government.

5. **Housing Support and Foreclosure Prevention**. Treasury will soon announce a comprehensive plan to reduce foreclosures that builds on the work of Congressional leaders and the FDIC. The plan will (a) be designed to drive down overall mortgage rates, (b) commit $50 billion to preventing avoidable foreclosures by helping to reduce monthly payments, (c) establish loan modification guidelines and standards for government and private programs, and (d) build flexibility into the Hope for Homeowners and the Federal Housing Administration modification programs.

6. **Small Business and Community Lending Initiative**. Over the next several days, President Obama, Treasury, and the Small Business Administration (SBA) will launch a new initiative to stop the precipitous decline in SBA lending through (a) use of the TALF to finance the purchase of AAA-rated SBA loans, (b) an increase in the guarantee for SBA loans from as low as 75 percent to as high as 90 percent, and (c) a streamlined and cheaper SBA loan application process.

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Attorneys in Covington’s Financial Institutions Group have advised many clients on recent financial services and banking developments. The Financial Institutions Group’s expertise derives from advising clients on the impact of such developments over the course of the past three decades. Please do not hesitate to contact any member of our Financial Institutions Group, including the undersigned, should you have any questions.

[1] For an overview of these restrictions, please see our prior e-alert Treasury Issues New Executive Compensation Guidelines Under the TARP (February 5, 2009).

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