



BROWN RUDNICK'S STRUCTURED RESOLUTION GROUP

# US TREASURY BAIL-OUT ALERT

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## Distressed mortgage assets? What distressed mortgage assets?

The Emergency Economic Stabilization Act of 2008 (EESA), introduced in September and signed into law earlier this month, was touted as the government's response to the credit market's meltdown caused (in large part) by the subprime mortgage crisis. Naturally, the core of the government's bail-out plan was considered to be the Treasury's "troubled asset relief program" (TARP): the power to purchase troubled residential and commercial mortgage-related securities (and other financial instruments) from the U.S. financial institutions. The \$700 billion allocated to the bail-out program (or even the immediately available \$250 billion) could buy the government a lot of mortgage-backed paper. The biggest problem with the government's bail-out plan was expected to be the lack of implementation details, most notably the pricing and auction mechanisms. The second issue had to do with the timing: the stock and credit markets were in a free fall and drastic and immediate measures were required to restore not just the liquidity but the confidence of Wall Street and Main Street. Finally, the third and not surprising problem: there is no shortage of supplicants for government largesse.

As detailed in our prior Bail-Out Alerts, the Treasury made the decision to exercise its broad powers under the EESA to take equity stakes in the largest financial institutions by purchasing up to \$250 billion (out of the \$700 billion authorized by Congress) of senior preferred shares in such institutions under the so-called Capital Purchase Program (CPP). On October 20<sup>th</sup>, the Treasury unveiled the application guidelines for the financial institutions interested in participating in the CPP, plus additional program details, which are summarized as follows:

- **Eligibility.** The following institutions are eligible to participate in the CPP: bank holding companies, financial holding companies, insured depository institutions and savings and loan holding companies that engage solely or predominantly in activities that are permissible under relevant laws for financing holding companies.
- **Application Procedure.** First, the applicant reviews the program information on the Treasury's website and consults with its primary regulator (e.g., Federal Reserve, FDIC, OCC or OTS). Second, the applicant submits the application form to that primary regulator. Finally, the primary regulator evaluates the application through a standardized process and sends the application, along with its recommendation, to the Office of Financial Stability at the Treasury. The Treasury then reviews and decides whether or not to make a particular capital purchase, giving considerable weight to the recommendations of the applicable primary regulator. As required by the law, all completed transactions are announced to the public within 48 hours of execution.

- **Form of Capital.** The form of capital qualifying for purchase under the CPP is cumulative perpetual preferred stock for institutions that are a bank holding company or a savings and loan holding company, and non-cumulative perpetual preferred stock for insured depository institutions that are not controlled by a holding company.
- **Investment Limits.** The maximum amount of capital eligible for purchase by the Treasury is the lesser of three percent of the total risk-weighted assets (applying applicable risk-weighted capital rules) of the applicant or \$25 billion. The minimum amount eligible for purchase is one percent of the total risk-weighted assets of the applicant.
- **Warrants.** The government will not only own shares in the participating institutions expecting to yield reasonable returns, but will also receive warrants for common shares in these financial institutions.
- **Deadlines.** The deadline for applying for the program (which the Treasury insists will not be implemented on a first-come-first-served basis, but instead through a sensible allocation of \$250 billion to permit all qualifying banks to participate) is November 14, 2008.

The stock-purchase arrangements between the Treasury and nine of the largest financial institutions were signed on October 26<sup>th</sup>, and the funds – totaling \$125 billion – will be transferred this week. In addition to funding the financial behemoths, the Treasury is also working with approximately 20 regional banks to arrange the purchase of another \$125 billion worth of preferred stock in such institutions by the end of 2008. Carved out from these funds are \$7.7 billion to effectuate the acquisition of National City by PNC Financial. Other rumored beneficiaries of the CPP include KeyCorp and SunTrust Banks Inc. The idea, again, is that such capital infusions will help unfreeze the credit markets and will result in availability of funds to consumers and businesses alike.

Another interesting component (which came about as a sweetener for the conservative opponents of the original bail-out plan) of the EESA is the insurance option: EESA requires the Treasury to establish a voluntary insurance program to guarantee the timely payment of interest and/or principal on troubled assets. As in the case of TARP, the Treasury's plan is short on specifics (e.g., assets to be guaranteed, premiums, etc.). The Treasury is currently awaiting the feedback of market participants, including the Securities Industry and Financial Markets Association, on how to best structure the program. In the meanwhile, large insurance companies, such as MetLife Inc. and Prudential Financial Inc., have expressed interest in participating in the CPP by selling equity interests to the Treasury. However, unlike the banks, most insurance providers are financially healthy and are generally immune from many problems associated with banking institutions (such as investment withdrawals and bank runs). Also, while it is true that most insurance companies have suffered significant losses and write-downs, rating downgrades and falls in stock prices, it is unclear how capital infusion in these institutions would help the government resolve the credit crunch problem.

There is now a concern that, due to the size of the program and the range of discretion available to the Treasury, the bail-out plan may become a hostage to Washington's interest and lobby groups. On October 24<sup>th</sup>, The Financial Services Roundtable, a trade group advocating the interests of financial services companies, sent a letter to the Treasury asking that broker-dealers, insurance companies, car makers and financial institutions owned by foreign corporations be included in the CPP. Finally, it has been reported that state and local governments have expressed



interest in participating in the government's bail-out program by having the Treasury purchase state and municipal bonds.

Despite the flurry of implementation procedures, procurements and announcements made by the Treasury since the passage of the rescue plan, one crucial sector remains neglected: the American homeowners. Last Thursday we received news of a program being developed by the FDIC that would finally aim to rework troubled mortgages and avoid foreclosures. Although the plan details are still in the works, the general idea entails the development of standardized criteria that would be used by servicers of mortgages to modify mortgages, which would then be eligible for a federal guarantee against default. Judging by the preliminary results of a similar program established by the FDIC after taking over IndyMac Bank last year, which resulted in the modification of 60,000 troubled loans, many believe that this program could be an effective and much needed action by the Government in its effort to alleviate the current economic crisis.

We are still in the very early stages of the Treasury's program and it will be some time before we can evaluate the impact (if any) of the Treasury's bail-out plan on the economy. However, if perception is the key, then the government has had mixed results in its attempts to solve the economic issues on Wall Street and Main Street. Now, with the Treasury monies potentially going to fund issuances by state and local governments, the question must be asked whether what began as a rifle-shot approach to jump-start an immobilized banking system is morphing into a scatter-shot approach to address broader issues caused by a recessionary economy. If so, should \$700 billion be viewed as only a downpayment? Stay tuned.

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