

# FS Regulatory Briefs\*

## The Emergency Economic Stabilization Act of 2008: Initial Highlights, Issues and Implementation

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On October 3, 2008, the Congress passed and the President signed into law the **Emergency Economic Stabilization Act of 2008** (the "Act" or "EESA"). During its short legislative history, the Act bore a number of descriptions -- from the Troubled Asset bill, to the Economic Rescue bill, to the Bailout bill and worse. It is now secure in its identity as EESA and its overriding legislative purpose -- "to restore liquidity and stability to the financial system of the United States."

### Scope of the Program

The centerpiece of EESA is its creation of the Troubled Assets Relief Program ("TARP") which provides the Secretary of the Treasury (the "Secretary") with the authority to purchase certain troubled assets from financial institutions. Treasury is to receive authority to purchase troubled assets in tranches. Upon enactment, the purchase authority is limited to \$250 billion outstanding at any time, which can be raised to \$350 billion outstanding if the President certifies to Congress that Treasury needs to exercise such additional authority. The outstanding amount can be raised to a maximum of \$700 billion upon the request of the President, but Congress has 15 days to disapprove the request by passing a Joint Resolution. The President has the authority to veto the Congressional Joint Resolution.

The Secretary's authority to purchase (but not hold) troubled assets will terminate on December 31, 2009, unless extended by the Secretary to the date that is two years after enactment of EESA upon submission of a certification to Congress

In reviewing and analyzing EESA, it is important to recognize that the legislation is principally concerned with establishing the legal, regulatory and financial

architecture for TARP and that it confers significant discretion on the Secretary and a new Office of Financial Stability within Treasury. However, EESA also requires extensive oversight of how that discretion is to be exercised. Given the urgency with which EESA was drafted, there are and will be many questions as the law is implemented and TARP becomes operational. Hence our addition of the word "initial" to this summary.

The following highlights and issues are geared to our financial institution clients but will hopefully be of interest to all of our clients concerned with this unprecedented government effort to address urgently and responsibly a U.S. financial crisis with far-reaching implications for the U.S. and global economy.

### Key Definitions -- Eligible Financial Institutions and Troubled Assets

The two most important questions for financial institutions are (i) which financial institutions can participate in TARP, and (ii) what types of "troubled assets" may Treasury purchase?

**Financial Institutions.** The definition of "financial institutions" means any institution, including, but not limited to, any bank, savings association, credit union, security broker or dealer or insurance company, that is established and regulated under the laws of the United States (or any U.S. state, territory, or possession) and has significant operations in the United States. The only institutions expressly excluded are any central bank of or institution owned by a foreign government.

**Comment:** *It appears that U.S. branches and agencies of foreign banks qualify under the definition and that Treasury may include other institutions such as bank or financial holding companies and their nonbank*

subsidiaries. Treasury will have to determine what it means for an institution to have "significant operations" in the United States as there is no further guidance in EESA. In addition, the exclusion of foreign central banks and government-owned banks must be read with Section 112 of EESA which provides that, to the extent foreign financial authorities or banks hold troubled assets as a result of extending financing to financial institutions that have failed or defaulted on such financing, such troubled assets do qualify for purchase under TARP

**Troubled Assets.** The definition of "troubled assets" includes residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case were originated or issued on or before March 14, 2008 and the purchase of which the Secretary determines promotes financial market stability. Troubled Assets also may include any other financial instrument that the Secretary, after consultation with the Chairman of the Federal Reserve Board ("FRB Chairman"), determines the purchase of which is necessary to promote financial market stability.

**Comment:** During the period of legislative consideration, the definition of troubled assets was broadened to include "commercial mortgages." The focus of this expansion was apparently multi-family housing loans, which is consistent with one of several "considerations" enumerated in exercising authorities under EESA; namely, "the utility of purchasing other real estate owned and instruments backed by mortgages on multifamily properties." However, there is nothing in EESA to prevent Treasury from including other types of commercial mortgage loans so long as the Secretary determines the purchase promotes financial market stability.

#### **TARP: Policy Considerations, Authorized Actions, Initial Solicitations and Guarantee Program**

**Considerations.** TARP includes a long list of program "considerations" that inform the Secretary's exercise of

his authority under EESA, including decisions about which troubled assets to purchase. Among the factors to be considered are: (i) protecting the interests of taxpayers by maximizing overall returns, (ii) providing stability to financial markets, (iii) evaluating the long-term viability of a selling institution, (iv) ensuring all financial institutions are eligible, meaning no discrimination based on an institution's size, location or form of organization or the type and amount of troubled assets it holds, (v) providing assistance to financial institutions with assets of less than \$1 billion that suffered capital reductions based on the devaluation of Freddie Mac or Fannie Mae preferred stock, and (vi) the need to help families keep their homes.

**Actions.** TARP will be operated by the Office of Financial Stability and managed by an Assistant Secretary of Treasury appointed by the President and confirmed by the Senate. In exercising this authority Treasury must consult with the FRB, the Federal Reserve Bank of New York, the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), and the Secretary of Housing and Urban Development ("HUD").

The Secretary is authorized to take such actions as considered necessary to carry out EESA, including hiring, entering into contracts for services, designating financial institutions as financial agents, and establishing "vehicles that are authorized, subject to supervision by the Secretary, to purchase, hold, and sell troubled assets and obligations." Treasury can waive certain federal contracting regulations, but is directed to provide opportunities for minority and women-owned businesses. Treasury is required to issue regulations or guidelines to address conflicts of interest as soon as practicable after enactment.

**Initial Actions and Solicitations by Treasury.** On October 6, 2008, the Treasury posted three solicitations for financial agents to provide services that are needed for the effective implementation of the TARP authorized under the Act. The three services being sought are:

- Custodian, Accounting, Auction Management, and Other Infrastructure Services
- Securities Asset Management Services
- Whole Loan Asset Management Services

As noted, Treasury will select asset managers of securities separately from asset managers of mortgage whole loans. Asset managers will be financial agents of the United States, and not contractors, and will need to sign a Financial Agency Agreement with Treasury. Treasury indicates that it expects to designate multiple asset managers and sub-managers to obtain proper expertise in different asset types. Also, Treasury may decide not to select all asset managers at the same time, but rather in some sequence that matches Treasury's acquisition schedule and portfolio project plan. Responses to these initial solicitations were due by Oct. 8, 2008. Treasury expects to announce the results of initial selections from these three competitions the week of October 13th. Treasury has also issued interim guidelines for potential conflicts of interest related to the authorities granted under EESA. Information on the above solicitations and implementation issues generally is available on the new Treasury/EESA website -- <http://www.treas.gov/initiatives/eesa/>

**Guarantees.** EESA also requires Treasury to establish a program to guarantee troubled assets of financial institutions, and it is required to establish risk-based premiums for such guarantees sufficient to cover anticipated claims. Premiums collected will be deposited into a Troubled Asset Insurance Fund.

**Comment:** *While there are a number of considerations that Treasury must consider under EESA, the essential purpose is to provide liquidity to the financial system as a whole at the least cost to the taxpayer. House Banking Chairman Barney Frank has stated publicly that he does not expect the guarantee to be used because, in his view, it will not promote liquidity. Nonetheless, EESA requires by law that a guarantee program be implemented.*

## Program Guidelines, Pricing and Asset Management

**Guidelines.** Within 45 days of enactment or sooner, Treasury is required to issue program "Guidelines" describing the mechanism for the purchase of troubled assets, pricing and valuing troubled assets, the procedures for the selection of asset managers, and the criteria for deciding which troubled assets to purchase. Treasury must take steps to prevent unjust enrichment of financial institutions, including preventing resale of troubled assets to Treasury at a higher price than what the seller paid to purchase the assets. As noted above, Treasury on October 6, 2008, published solicitations for asset managers. EESA provides that Treasury may also appoint the FDIC as an asset manager.

**Pricing.** Pricing is to be the "lowest price ... consistent with the purposes" of the Act. Treasury may use auctions, including reverse auctions, if feasible, in purchasing assets. In making direct purchases, Treasury is to take steps to ensure that direct purchases are at "reasonable" prices and reflect the "underlying value of the asset." Treasury is not to purchase assets at a price higher than the seller's purchase price, except with respect to troubled assets acquired in a merger or acquisition or from a financial institution in conservatorship, receivership or Chapter 11 of the Bankruptcy Code.

**Manage Assets.** The Secretary has broad authority to manage the troubled assets it purchases, including the revenues and portfolio risks of such assets. Treasury also may, at any time, exercise any rights received in connection with such assets.

Treasury may hold assets acquired until maturity or for resale and sell at such time as the market is "optimal" for selling such assets at a price that will maximize returns for the Federal Government. Treasury is also to encourage private sector participation in participating in the purchase of troubled assets and to invest in financial institutions

**Comment:** *The EESA is drafted to provide the Treasury with broad authority to design and implement the TARP, which means there are many details to be determined in the implementation process. We anticipate four or five categories of transactions that the TARP likely will accommodate: purchase/sale of qualifying assets without continuing involvement; purchase/sale of qualifying assets with continuing involvement; guarantee of qualifying assets; and secured financing of qualifying assets. Additional transactions that could be a consequence of these categories include acquisition, management and disposition of real property and of equity interests in participating financial institutions. Based on Treasury's past experience and testimony on the legislation, there is a view that Treasury may focus initially on developing an auction process whose goals would be price discovery for and transparency of Treasury's activities. According to remarks made by the Secretary during Congressional consideration, the initial auctions may be for smaller amounts.*

#### **TARP Participants -- Executive Compensation Requirements & Treasury Receipt of warrants**

**Executive Compensation.** Executive Compensation requirements will apply to financial institutions that sell troubled assets to Treasury. When Treasury purchases assets directly, the institution must observe executive compensation and corporate governance standards to be set by Treasury for the duration of the period that the Treasury holds a debt or equity position in the financial institution (see later discussion of warrants). When assets are purchased at auction, an institution that has sold more than \$300 million of assets (including direct purchases) is prohibited from entering into any new employment contract with a senior executive officer that provides golden parachute payments in the event of an involuntary termination, bankruptcy filing, insolvency or receivership. Treasury must issue guidance within 60 days on these provisions.

EESA also amends the Internal Revenue Code to limit the annual deductible compensation to \$500,000 in any year that EESA is in effect for a covered executive

(CEO, CFO, or one of the top three most highly compensated employees) of a financial institution that has sold more than \$300 million of assets. The Act further amends the Internal Revenue Code to impose a 20% golden parachute tax, as well as the loss of corporate tax deduction, on severance payments received by covered executives of the financial institutions participating in the relief program even in the absence of a change in control.

**Warrants.** Treasury may not purchase or commit to purchase any troubled assets without receiving non-voting common or preferred stock warrants from publicly held institutions or a senior debt instrument from other institutions. Warrants are to provide "reasonable participation" by Treasury for the benefit of taxpayers in equity appreciation (or a reasonable interest rate premium in the case of a debt instrument). However, a "de minimis" exception may be applied to cumulative transactions of troubled assets purchased from any one financial institution for the duration of the program not exceeding \$100 million. EESA permits the development of alternative forms of stakes for financial institutions legally prohibited from issuing warrants and debt instruments.

**Comment:** *The executive compensation standards will apply to senior executive officers, defined as the top five highly-paid executives of a public company and non public company counterparts Warrants provided to Treasury must contain anti-dilution provisions to protect the value of the securities in various market transactions, such as stock splits, stock distributions, dividends or mergers. The specific provisions are to be determined by the Secretary. The combination of determining a "reasonable price" and receipt of warrants and/or other equity instruments could be a means through which the Treasury can infuse capital into participating financial institutions.*

## Oversight and Recoupment

**Oversight.** EESA establishes four oversight mechanisms for the TARP:

- A Financial Stability Oversight Board to review the exercise of authority and to make recommendations. Members include the FRB Chairman, the Secretary, the Director of the Federal Home Finance Agency, the Chairman of the SEC and the Secretary of HUD.
- An independent Office of Inspector General also is established for TARP.
- A Congressional Oversight Panel is created to report to Congress.
- GAO will also have oversight and audit authority.

**Recoupment.** Four years after enactment, a report will be submitted to Congress concerning the net results of the TARP at that time. If there is a shortfall, the President is required to submit proposed legislation to Congress to recoup the shortfall from the “financial industry” – not just TARP participants.

**Comment:** *In addition to the several means of oversight, the Act also requires reports to begin before the expiration of the 60-day period beginning on the first exercise of purchase or insurance authority, whichever comes first, and every 30-day period thereafter,*

## Foreclosure Mitigation and Home Ownership

Treasury must implement a plan that seeks to maximize the assistance for homeowners and for renters in acquired multifamily properties, and Treasury also must encourage servicers of underlying mortgages to use the HOPE for Homeowners Program and other available programs to assist borrowers in avoiding foreclosure and to assist renters in staying in acquired multifamily properties. In particular, Treasury must coordinate with other Federal Government entities holding troubled assets to identify opportunities for acquisition of classes of troubled assets for the purpose of facilitating loan

modifications and restructurings. In addition, Treasury must protect Federal, State, and local rental subsidies on residential rental properties it acquires, and must consent to reasonable requests for loss mitigation.

Other Federal agencies owning or controlling assets secured by residential real estate must also implement similar foreclosure mitigation effort plans within 60 days of enactment and report to Congress every 30 days thereafter on the number and type of loan modifications made, and the actual foreclosures occurring during each reporting period. The other agencies include the Federal Housing Finance Agency (in its capacity as conservator for Fannie Mae and Freddie Mac), the FDIC (in its capacity as a bridge bank for any failed institution), or the FRB (in its capacity on behalf of any Federal Reserve Bank).

**Comment:** *The Federal Housing Administration announced the beginning of The HOPE for Homeowners program on October 1, 2008 -- it ends on September 30, 2011. The program is available only to owner occupants and offers 30-year fixed rate mortgages. In many cases, to avoid what would be an even costlier foreclosure; banks will have to write down the existing mortgage to 90 percent of the new appraised value of the home. The Act amended the law so that the Board overseeing the Hope for Homeowners program may allow for the outstanding principal obligation on a loan refinanced under the program to exceed 90 percent and also made certain other changes to facilitate use of the program.*

## FDIC Temporary Insurance Increase and FRB Payment of Interest on Reserves Are Now Effective

As authorized by the Act, the FDIC announced a temporary increase (to carry through December 31, 2009) in the FDIC insurance limit to \$250,000 per depositor. A similar increase for the National Credit Union Share Insurance Fund was also authorized by the Act.

The Act accelerated the date for the payment of interest on Federal Reserve balances to October 1, 2008.

Employing the accelerated authority, the FRB has approved a rule to amend its Regulation D to direct the Federal Reserve Banks to pay interest on required reserve balances (that is, balances held to satisfy depository institutions' reserve requirements) and on excess balances (balances held in excess of required reserve balances and clearing balances).

**Comment:** *As described by the FDIC in its announcement, basic FDIC insurance coverage is now \$250,000 per owner for single accounts; \$250,000 per co-owner for joint accounts (meaning \$500,000 for a joint account equally owned); \$250,000 per owner for IRA and other retirement accounts; and \$250,000 per owner per beneficiary for trust accounts subject to specific limitations and requirements.*

*The FRB has indicated that the interest rate paid on required reserve balances will be the average targeted federal funds rate established by the Federal Open Market Committee over each reserve maintenance period less 10 basis points. The rate paid on excess balances will be set initially as the lowest targeted federal funds rate for each reserve maintenance period less 75 basis points.*

## Required Studies

The Act requires several studies, including

**Regulatory Reform.** A study by the Secretary analyzing the current state of the regulatory system and its effectiveness at overseeing participants in the financial markets, including the over-the-counter swaps market and the GSEs. The Study is to include recommendations on whether any participants in the financial markets that are currently outside the regulatory system should be subject to the regulatory system and the enhancement of the clearing and settlement of over-the-counter swaps.

**Leverage.** A study and report by the Comptroller General to Congress on the role which leverage and sudden deleveraging of financial institutions was a factor behind the current financial crisis.

**Mark-to-Market Accounting.** A study by the SEC, in consultation with the FRB and the Treasury, on mark-to-market accounting standards as provided in *Statement Number 157 of the Financial Accounting Standards Board*, including its effects on balance sheets, impact on the quality of financial information, and other matters, and to report to Congress within 90 days on its findings.

**Comment:** *The Act also restates the SEC's authority to suspend the application of Statement Number 157 of the Financial Accounting Standards Board if the SEC determines that it is in the public interest and protects investors.*

## Tax Relief Provisions

The Act provides that any gains or losses on sales or exchanges of Fannie Mae and Freddie Mac preferred stock owned on Sept. 6, 2008, or sold or exchanged on or after Jan. 1, 2008 and before Sept. 7, 2008, by certain financial institutions will be treated as ordinary income or losses. The provision is designed to allow banks to obtain the tax benefit of the loss on the preferred stock and is intended to reduce any need by such banks to obtain additional capital and to prevent some community banks from suffering significant declines in capital.

The Act also provides assistance to homeowners in the form of tax relief by excluding qualified principal residence debt that is canceled in foreclosure or through a write-down from taxable income. However, such relief is not extended to home equity loans. This tax relief is extended through the end of 2012.

## Additional Information

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