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CLIENT MEMORANDUM

U.S. Treasury Department Unveils New Financial Stability Plan

February 11, 2009

On February 10, 2009, the U.S. Department of the Treasury (the "Treasury Department") announced a much-awaited plan to overhaul federal efforts to stabilize, and lead to the ultimate recovery of, U.S. financial institutions and to address the credit crisis. The Financial Stability Plan comes in the wake of intensifying pressures on the financial services sector and concerns that the previous efforts to stabilize the financial system have lacked sufficient effectiveness, transparency and oversight.

Characterizing the federal response as both comprehensive and forceful, Treasury Secretary Timothy F. Geithner outlined the principal components of the Financial Stability Plan, including: (1) the creation of a Public-Private Investment Fund to address the toxic, "legacy" assets on the books of many financial institutions; (2) a coordinated effort with the Board of Governors of the Federal Reserve System (the "Federal Reserve") to expand, in both size and scope, consumer and business lending efforts; and (3) the establishment of a new Financial Stability Trust to hold the Treasury Department's capital investments in financial institutions that under the new plan will be subject to revised eligibility screening procedures, additional conditions connected to the receipt of any new investments by the Treasury Department and enhanced disclosure requirements regarding the use of government funds.

A. PUBLIC-PRIVATE INVESTMENT FUND: AN EMPHASIS ON PRIVATE PARTICIPATION

A centerpiece of the Financial Stability Plan is the establishment of the Public-Private Investment Fund (the "Fund"), a collaborative initiative by the Treasury Department, the Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC"). The Fund would use public financing along with private investments to acquire troubled financial assets that have been widely perceived as being at the heart of the credit crisis and the dramatic financial events since last fall. The new program, however, is still being designed and a range of different structures for the program are being explored.

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While it has been referred to colloquially as an "aggregator" or "bad" bank, the Fund would not be a replica of past approaches to absorb and market the bad assets of banks, most notably the creation of the Resolution Trust Corporation in connection with the savings and loan crisis of the late 1980s.

The defining features of the Fund depend on active private sector participation. First, the Financial Stability Plan envisions putting public and private funds "side-by-side" to finance transactions related to such troubled assets. It does not articulate any specific private sector capital commitments, but the Treasury Department expects the Fund to "use public financing to leverage private capital on an initial scale of up to $500 billion," with the potential to provide up to $1 trillion in public-private financing. Also, while the exact structure of the Financial Stability Plan is still being designed, it is also expected that certain guarantees will be offered to limit the risk associated with investments in the troubled assets and entice private investors. Second, the Financial Stability Plan relies heavily upon private sector pricing of troubled assets, including using private asset managers to assist in valuation efforts. Secretary Geithner noted that such an approach is consistent with the overall design of the Fund: to encourage private sector equity contributions in large-scale asset purchases.

As the contours of the Financial Stability Plan continue to evolve, the Treasury Department expects to solicit input from the private sector on how the Fund should be specifically designed and operated.

B. THE TERM ASSET-BACKED SECURITIES LOAN FACILITY: EXPANDING CONSUMER AND BUSINESS LENDING EFFORTS BY UP TO $1 TRILLION

Secretary Geithner also announced a joint initiative of the Federal Reserve and the Treasury Department to encourage consumer and business lending. This component of the Financial Stability Plan expands the Term Asset-Backed Securities Loan Facility ("TALF") that was announced in late November 2008 and that is expected to become operational within a few weeks. The TALF, both as originally contemplated and as substantially expanded under the Financial Stability Plan, is intended to relieve the strain in the asset-backed securities ("ABS") markets and increase credit availability and economic activity by facilitating the renewed issuance of consumer and small business ABS at more normal interest rate spreads.

TALF is a Federal Reserve credit facility intended to make credit available to consumers and small businesses by facilitating the issuance of ABS. Under the original TALF, the Federal Reserve Bank of New York announced that it would make up to $200 billion of three-year, non-recourse loans to eligible borrowers that pledge newly-issued U.S. dollar-denominated ABS that have the highest credit rating and that meet various other eligibility criteria. The underlying credit exposures of eligible ABS under the original TALF must be auto loans, student loans, credit card loans or small business loans fully guaranteed by the U.S. Small Business Administration ("SBA"). Each TALF loan would be in the amount of the eligible collateral less a haircut (for example, a 10 percent haircut for prime retail credit card collateral with a 4-5 year expected life). Under the original TALF, the Treasury Department was to provide $20 billion (allocated from the Treasury's Troubled Asset Relief Program) of credit protection to the Federal Reserve Bank of New York. The Federal Reserve Bank of New York had issued on February 6, 2009 the final terms and conditions and proposed documentation for its original TALF program.[1]

TALF funding is designed to permit ABS investors to benefit from leverage (with a 10 percent haircut, the investor will have initial leverage of 10X; with amortization of the ABS and a constant haircut, the leverage would decline over the life of the TALF loan). Under TALF, investors are not required to mark the collateral value to market (investors do not have to top up collateral) and, because TALF loans are nonrecourse, losses would be limited to the amount of the haircut.

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1 *See* http://www.federalreserve.gov/newsevents/press/monetary/20090210b.htm.

The Financial Stability Plan dramatically increases the size of the TALF program to up to $1 trillion of TALF lending by the Federal Reserve Bank of New York, backed by up to $100 billion of support from the Treasury Department. Eligible assets would be broadened to include commercial mortgage-backed securities; in the future other asset classes, such as private-label residential mortgage-backed securities and assets collateralized by corporate debt, may be included as eligible assets.

C. ESTABLISHMENT OF THE FINANCIAL STABILITY TRUST AND A HOST OF NEW REQUIREMENTS AND CONDITIONS RELATED TO PUBLIC INVESTMENTS IN FINANCIAL INSTITUTIONS

A third component of the Financial Stability Plan is the establishment of the Financial Stability Trust (the "Trust") to provide for and manage direct capital investments in financial institutions by the federal government under the Capital Assistance Program of the Troubled Asset Relief Program ("TARP").[2] Building on the Capital Assistance Program of TARP, the Financial Stability Plan introduces a number of additional elements designed to address previous criticisms of the existing program, including introduction of a coordinated test by banking regulators to assess a bank's financial condition, as well as new requirements and conditions associated with the receipt and use of capital assistance.

Implementing "Stress Tests" and Improving Disclosures on Exposures

The Financial Stability Plan contemplates a comprehensive supervisory review process and "stress test" of every banking institution with assets in excess of $100 billion. The coordinated assessment by the Treasury Department, the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency and the Office of Thrift Supervision is designed to determine whether a particular bank has sufficient capital to continue lending and to absorb losses that could result from a more severe economic decline. In conjunction with such stress tests, the Treasury Department will also be working with the U.S. Securities and Exchange Commission ("SEC") and accounting standard-setters to improve disclosure requirements and practices relating to exposures of financial institutions.

Capital Assistance Program

The Financial Stability Plan provides for direct investment of "contingent equity," which will be structured as a preferred security investment from the Treasury Depart-ment that can be converted into common equity if needed to preserve lending in a worse-than-expected economic environment.

Monitoring and Reporting Requirements

Responding to concerns over the lack of transparency and accountability of previous distributions of TARP funds, the Treasury Department will require all applicants for funds under the Financial Stability Plan to submit a plan on how such funds will be used to bolster their lending capacity. The plans will be publicly available following the Treasury Department's completion of its capital investment in the particular institution.[3]

Once a troubled financial institution receives capital assistance under the Financial Stability Plan, it will be subject to monthly reporting requirements on the nature and extent of its lending, including breakdowns by loan category, statistics on new loan origination to businesses and consumers and the number of asset-backed and mortgage-backed securities that have been purchased with such funds. Significantly, to measure the impact of any capital assistance received on lending, recipient institutions will be required to describe what their lending would have been had they not received such funds. Recipient institutions that are public filers with the SEC will have to

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[2] TARP was implemented pursuant to the Emergency Economic Stabilization Act of 2008 (the "Act"). For more information on the Act, see the Firm's client memorandum dated October 3, 2008, *available at* http://www.simpsonthacher.com/content/publications/pub754.pdf.

[3] The Financial Stability Plan states that all information disclosed or reported to the Treasury Department by recipient institutions will also be available to the public at www.financialstability.gov upon completion of the capital investment in the institution.

disclose such information in a Current Report on Form 8-K, simultaneously with the filing of any Quarterly Report on Form 10-Q or Annual Report on Form 10-K, as applicable.

New Conditions Tied to Capital Assistance

In response to criticism of the lack of accountability of financial institutions receiving federal assistance, the Treasury Department announced a number of new conditions to a financial institution's receipt of capital assistance under the Financial Stability Plan.

As announced earlier this month,[4] the Treasury Department will require institutions receiving exceptional federal assistance to adopt various new limits on executive compensation, including limiting the total annual compensation of each senior executive to $500,000, plus restricted stock payable only after the government has been repaid.

Financial institutions receiving new capital assistance will also be restricted from taking a range of corporate actions, including paying quarterly dividend payments on common stock in excess of $0.01 and repurchasing any privately held shares of stock. Furthermore, recipient institutions will be restricted from making cash acquisitions of healthy firms until obligations held by the Treasury Department are satisfied, although the Financial Stability Plan leaves open the possibility for exceptions if an applicable banking supervisor approved an acquisition in the context of a restructuring plan.

D. OTHER PROPOSED ACTIONS

The Treasury Department will also require all recipients of capital investments under the Financial Stability Plan to participate in foreclosure mitigation programs to be announced by the Treasury Department as best practice guidelines. At least $50 billion will also be devoted to an initiative designed to prevent foreclosures of owner-occupied homes by reducing monthly mortgage payments, although details of the initiative have not been released. In addition, the Treasury Department will institute national standards for loan modifications; such standards are expected to be applicable to, among other entities, the major GSEs.

In light of the increased capital pressures on banks and the unattractiveness of SBA loans in the secondary market, the Financial Stability Plan will also address the precipitous fall in SBA lending. The Treasury Department plans to announce in the near future a Small Business and Community Bank Lending Initiative with the SBA to increase SBA lending by financing the purchase of AAA-rated SBA loans and pursue efforts to increase the federal guarantee for SBA loans to 90 percent.

CONCLUSION

The Treasury Department's announcement of the Financial Stability Plan included only the broad outlines of the initiatives described above, several of which are still being developed. Specific plan components will be formulated and released for public comment over the coming weeks. As a result, the Financial Stability Plan raises a number of questions which will be clarified as further information becomes available. We will provide further updates on components of the Financial Stability Plan as developments occur

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[4] *See* http://www.treasury.gov/press/releases/tg15.htm.

The names and office locations of all of our partners, as well as memoranda regarding recent corporate reporting and governance developments, can be obtained from our website, www.simpsonthacher.com.

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