PUBLICATION

Analysis of Emergency Economic Stabilization Act of 2008

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On October 3, President George W. Bush signed H.R. 1424, "The Emergency Economic Stabilization Act (EESA) of 2008" into law. Broadly speaking, the legislation will give brand new authority to the United States Treasury Department to purchase distressed assets associated with tainted mortgages, securities and other financial instruments held by financial institutions. Such new authority is in addition to existing authority held by the Federal Deposit Insurance Corporation (FDIC) to purchase bad assets of insured depository institutions and the Federal Reserve to create Term Auction facilities or to directly purchase mortgage assets, as it did in the case of the Bear Stearns transactions in March.

The following is a summary of EESA's key provisions.

TARP - Under a newly created Troubled Assets Relief Program (TARP), the Treasury Department, in consultation with the Federal Reserve, the Securities Exchange Commission (SEC), the Federal Housing Regulatory Agency and the Department of Housing and Urban Development (HUD), will be authorized to purchase, insure, hold and sell a wide variety of troubled assets, particularly those that are based on or related to residential or commercial mortgages issued prior to March 14, 2008 (the category of "troubled assets" could be expanded based on a determination by Treasury and the Federal Reserve).

Program Length - The TARP will expire on December 31, 2009, but could be extended by one year to December 31, 2010 upon certification of need submitted to Congress by Treasury.

Program Guidelines - Program guidelines, which includes a mechanism for purchasing trouble assets, pricing and valuing the assets and criteria for identifying troubled assets for purchase, are required to be published by the Secretary within two business days after the first purchase of a troubled asset or within 45 days after the Act is enacted into law. The Act provides the Secretary with significant flexibility and discretion in designing and establishing those guidelines as well as identifying the assets to be purchased. In addition, the Secretary is directed to take steps it deemed necessary to prevent unjust enrichment for financial institutions participating in the TARP.

Until the Secretary purchases the first tranche of troubled assets, its processes, valuation methodologies and contractual requirements will not be known. Those processes are required to be published within two business days after the first troubled assets have been purchased. At that time, financial institutions considering participating in the TARP will be able to access those processes and guidelines and to determine whether or not it wishes to participate in the program.

Recoupment - If, after five years from the enactment date, it is determined that the TARP resulted in a net loss to the U.S. government, the President will be required to submit legislation to Congress to authorize the government to recoup the shortfall directly from the financial institutions that benefited from the TARP participation.

Asset Purchasing Authority - Asset purchasing authority will be phased-in during three stages: $250 billion in asset purchase authority will be available immediately, followed by another $100 billion upon presidential request, and another $350 billion upon Congressional approval. The bill will also allow Treasury to insure troubled assets, including mortgage-backed securities, with premiums collected from participating financial institutions.

Foreclosure Mitigation Efforts & Homeowner Assistance - For mortgages and mortgage-backed securities (MBS) acquired through the TARP, the legislation will require Treasury to implement a plan to mitigate foreclosures and to encourage servicers of mortgages to modify loans. The Federal Reserve, FHFA and FDIC will be required to implement plans to mitigate foreclosures, including loan modification, in connection with residential loans and securities under their control. The Hope for Homeowners program, which provides for loss mitigation by mortgage lenders and servicers, will be strengthened to increase eligibility and improve the tools available to prevent foreclosures. Note: The legislation does not contain bankruptcy-related "cram down" provisions.

Mark-to-Market Accounting - The SEC will have authority to suspend the application of the Financial Accounting Standards Board's (FASB) mark-to market accounting standards and be required to report to Congress on mark-to-market standards. It is unlikely that the SEC will actually suspend these accounting standards. On September 30, 2008, the SEC issued an interpretive release which allows some relief to institutions attempting to value mortgage securities for which the markets have either slowed considerably or disappeared altogether. A number of prominent institutions, such as JP Morgan Chase, have opposed any efforts to suspend mark-to-market accounting standards.

Losses on Preferred Stock - Financial institutions which have suffered losses on Fannie Mae and Freddie Mac preferred stock will be permitted to take such losses against ordinary income. This aspect of the Act will be particularly helpful for community banks which suffered the most serious impact with the failure of Fannie Mae and Freddie Mac.

Executive Compensation Limitations - Institutions selling assets under the TARP will be required to agree to certain limitations on executive compensation, including the requirement that executives return certain bonuses or other incentive payments, and will be subject to a 20 percent excise tax on golden parachute payments. This is the section of the Act which is designed to ensure that executives of financial institutions holding troubled assets do not personally benefit from the government bailout.

Equity Participation - The Secretary may not purchase any troubled asset unless the financial institution (which has securities traded on a national securities exchange) issues to the government a warrant to purchase nonvoting common stock or preferred stock in the financial institution. This provision is intended to ensure that taxpayers are protected from suffering losses from the ultimate sale of troubled assets purchased by the Secretary, but also to treat the taxpayer as an investor and allow a profit to be made on the purchases.

FDIC - The FDIC depository insurance program will be increased from $100,000 to $250,000 through December 31, 2009, which will include enhanced authority to borrow from Treasury and to charge participating institutions premiums to pay for such increased coverage. FDIC will be allowed to be selected by Treasury as an asset manager for residential mortgage loans and MBS purchased by Treasury under the TARP.

Fraudulent Business Practices - Depository financial institutions will be specifically prohibited from the misuse of the FDIC logo and name to falsely represent that deposits are insured. The legislation will strengthen enforcement by appropriate federal banking agencies, and allow the FDIC to take enforcement action against any person or institution where the banking agency has not acted. Federal financial regulatory agencies are required to cooperate with the FBI and other law enforcement agencies investigating fraud, misrepresentation and malfeasance with respect to development, advertising and sale of financial products.

Program Oversight - The following oversight programs will be created to ensure proper management of the TARP:

- *Financial Stability Oversight Board* - The Board, made up of representatives from Treasury, the Federal Reserve, HUD, the Federal Home Finance Agency (FHFA) and the SEC, will be charged with overseeing program implementation.
- *Congressional Oversight Panel* - The panel will be created to review the state of the financial markets, the regulatory system and the use of authority under the TARP. The panel will be required to report to Congress every 30 days and to submit a special report on regulatory reform prior to January 20, 2009, the date the new president is sworn–in.
- *U.S. General Accounting Office (GAO)* - The GAO will be authorized to conduct ongoing oversight of the activities and performance of the TARP, and to report every 60 days to Congress. The GAO will be required to conduct an annual audit of the TARP. In addition, the TARP will be required to establish and maintain an effective system of internal controls.
- *Special Inspector General for the TARP* - An Office of the Special Inspector General for the TARP will be authorized to conduct, supervise and coordinate audits and investigations of the actions undertaken by the Treasury Department during program administration. The Special Inspector General is required to submit a quarterly report to Congress summarizing its activities and the activities of the Treasury Department authorized by EESA.