Crisis in the Financial Markets: Legislative and Regulatory Responses

The recent unprecedented events affecting the global financial markets triggered equally unprecedented responses from Congress and the federal financial regulatory agencies. In an attempt to restore liquidity to the credit markets, the federal government has become a key player in the financial services industry. While the full implications of the legislative and regulatory actions will not be evident for some time, these responses create immediate opportunities for financial institutions and other market participants.

Emergency Economic Stabilization Act of 2008

Overview. The Emergency Economic Stabilization Act of 2008 (the Act) was signed by President Bush on October 3, 2008. The Act's primary purpose is to provide authority to the Secretary of the Treasury (the Secretary) to restore liquidity and stability to the U.S. financial system by establishing the Troubled Asset Relief Program (TARP). Under TARP, the Secretary has authority to purchase "troubled assets" from "financial institutions."

"Troubled asset" is defined broadly to include (1) residential and commercial mortgages and any related securities originated or issued before March 14, 2008, and (2) any other financial instrument that the Secretary determines the purchase of which is necessary to promote financial market stability.

"Financial institutions" includes banks, savings associations, credit unions, security brokers and insurance companies having significant operations in the United States, but excludes any central bank or institution owned by a foreign government.

Immediately available to the Secretary is $250 billion; another $100 billion becomes available upon the written certification of need by the President to Congress; and an additional $350 billion will become available upon a further certification of need by the President unless Congress passes a joint resolution disapproving the increase within 15 days after submission by the President.

In addition to the purchase of troubled assets, the Secretary is required to establish an insurance program to guarantee troubled assets that were issued or originated before March 14, 2008. Financial institutions that participate in this

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insurance program would have to pay insurance premiums based on the credit risk of the assets being guaranteed.

Implementation. TARP is to be implemented by the newly created Office of Financial Stability (OFS) within the Office of Domestic Finance of the Treasury Department. Treasury Secretary Paulson designated Neel Kashkari as the Interim Assistant Secretary of the Treasury to oveersee OFS. The Act does not specify how TARP is to be operated but requires the Secretary to publish "program guidelines" within 45 days after enactment or, if earlier, the second business day after the first purchase under TARP.

Other Provisions. The Act contains numerous other provisions governing the TARP program including extensive oversight and reporting, taxpayer protection provisions, limits on executive compensation and provisions intended to provide assistance to homeowners facing default on their mortgage loans.

Capital Purchase Program

Although the Act was originally designed to create a program for the purchase of "toxic assets" from financial institutions, continuing turmoil in the financial markets after enactment of the Act led to the announcement of the TARP Capital Purchase Program (CPP) on October 14, 2008 which is designed to more quickly and directly address market concerns about the viability of U.S. financial institutions.

Direct Investments in Financial Institutions. The Treasury determined that it will utilize $250 billion under TARP to purchase nonvoting preferred stock issued by a "qualifying financial institution" which includes most U.S. bank holding companies, savings and loan holding companies, and banks and saving associations not controlled by a holding company. The amount of preferred stock may not be less than 1% of the issuer's risk-weighted assets or exceed the lesser of (a) $25 billion or (b) 3% of risk-weighted assets.

Terms of Preferred Stock. The preferred stock purchased by the Treasury under CPP will have a perpetual life, be senior to common stock and equal priority to outstanding preferred stock (other than any outstanding junior preferred stock), have a 5% cumulative dividend for five years and a 9% cumulative dividend thereafter and may not be redeemed for three years except with the proceeds of a "qualified equity offering " (the sale for cash of Tier 1 perpetual preferred stock or common stock).

Warrants. In connection with the purchase of preferred stock under CPP, the Treasury will receive warrants to purchase common stock having a value of 15% of the preferred stock.

At the time the CPP was announced, the Treasury also announced that $125 billion of the $250 billion available under the CPP would be used to purchase preferred stock from nine of the largest U.S. bank holding companies, leaving $125 billion for investment into other qualified financial institutions. To be eligible to participate in the CPP, qualifying financial institutions must elect to participate before 5 p.m. on November 14, 2008. As of this date, the Treasury has not issued any information on how a qualifying financial institution makes that election or what criteria will be used to determine eligibility and allocations under the CPP.

Temporary Liquidity Guarantee Program

Also on October 14, 2008 the Secretary took action allowing the FDIC to provide a 100% guarantee for newly issued senior unsecured debt of FDIC-insured depository institutions, U.S. bank holding companies, U.S. financial holding companies and U.S. savings and loan holding companies.

Scope of Liabilities. The guarantee applies to senior secured debt issued on or before June 30, 2009 including promissory notes, commercial paper and inter-bank funding. The principal amount of the debt covered by the guarantee may not exceed 125% of the debt that was outstanding as of September 30, 2008 that was scheduled to mature before June 30, 2009.

Maturity. The guarantee will only extend to June 30, 2012 even if the guaranteed debt has not matured by that date.

Fees. There are no fees for the first 30 days. Thereafter, the annual fee is 75 basis points multiplied by the amount of debt issued under this program.

FDIC Insurance

The Act, effective October 3, 2008 through December 31, 2009, increased the amount of FDIC insurance of depository accounts from $100,000 to $250,000. As part of the FDIC Temporary Liquidity Guarantee Program, there is no limit on the FDIC insurance of noninterest bearing transaction deposit accounts through December 31, 2009.

For More Information

In addition to the actions briefly summarized above, the Treasury has guaranteed amounts held in money market funds, announced a program to purchase commercial paper for entities which have been shut out of the commercial paper market and announced several other programs to provide liquidity to the financial markets. Please contact any member of Reinhart's Financial Markets Crisis Team to discuss how these legislative and regulatory initiatives affect you.

Links

Emergency Economic Stabilization Act of 2008

TARP Capital Purchase Program Term Sheet

FDIC Temporary Liquidity Guarantee Program