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Treasury Will Not Purchase Toxic Assets: Financial Rescue Plan

On November 12, 2008, Treasury Secretary Henry Paulson announced that changes in market conditions led the Treasury to reevaluate the allocation of remaining TARP funds. The purchase of illiquid mortgage-related securities, the so-called "toxic assets," was the announced plan when Congress enacted the Emergency Economic Stabilization Act. Within a week after enactment, though, Treasury announced the Capital Purchase Plan which envisioned the direct investment of $250 billion assets into U.S. financial institutions. Treasury has now abandoned the plan to purchase toxic assets, concluding that those purchases would not be, at this time, the "most effective way" to regain stability in the financial system. Instead, future uses of TARP funds will focus on continuing to build capital in financial institutions, reviving the market for securitizing consumer credit outside the banking system and reducing the risk of mortgage foreclosure.

While it provides few details, the announcement suggests the development of a future program to build capital in healthy financial institutions and perhaps nonbank financial institutions not eligible to participate in the existing Capital Purchase Program. This new program may leverage TARP investments by attracting private capital through matching investments. This new program will not begin until the existing Capital Purchase Program is completed and its impact evaluated.

In the consumer finance sector, the Treasury Secretary noted that the asset-backed securitization market has played a critical role in providing consumer credit which has been readily available at a lower cost. The asset-backed securitization markets for auto loans, student loans and credit cards have largely "come to a halt," reducing the availability and increasing the cost of this type of consumer credit which has contributed to the current economic downturn. Once again, Treasury is exploring the development of a liquidity facility using federal financing to induce private investment in the asset-backed securities markets.

The Treasury is also considering a number of ways to honor its commitment to Congress to achieve more aggressive mortgage modification standards. Now that illiquid mortgage securities will not be purchased under TARP, a number of other proposals are being considered to reach affordability targets for mortgage modification. The mortgage modification protocol developed by the FDIC in the

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IndyMac Bank receivership and the mortgage modification programs recently announced by Fannie Mae and Freddie Mac were cited as positive developments and additional programs, requiring substantial government subsidies, are also under review.

The announcement indicates that while the first priority is recovery and repair, global regulatory reform will be necessary to encourage long term stability. According to Secretary Paulson, "persistent and growing global imbalances fueled a dramatic increase in capital flows, low interest rates, excessive risk taking and a global search for return. These excesses cannot be attributed to any single nation." The first step toward a global solution will take place this weekend, as 20 of the largest economies of the world gather to discuss and address the crisis.

For more information, please contact any member of the Financial Markets Crisis team to determine how this development may affect you. The Treasury Department Press Release October 12, 2008: "Remarks by Secretary Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update" can be found on the U.S. Department of the Treasury website.