Information as of 10/12/08

Update:

Financial Markets in Crisis:

The Emergency Economic Stabilization Act of 2008 and Addressing Concerns of Solvency and Need for Capital for Banks

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Conclusions from Our October 7 Presentation, "TARP and EESA: What is it and What does it Mean to Community Banks"

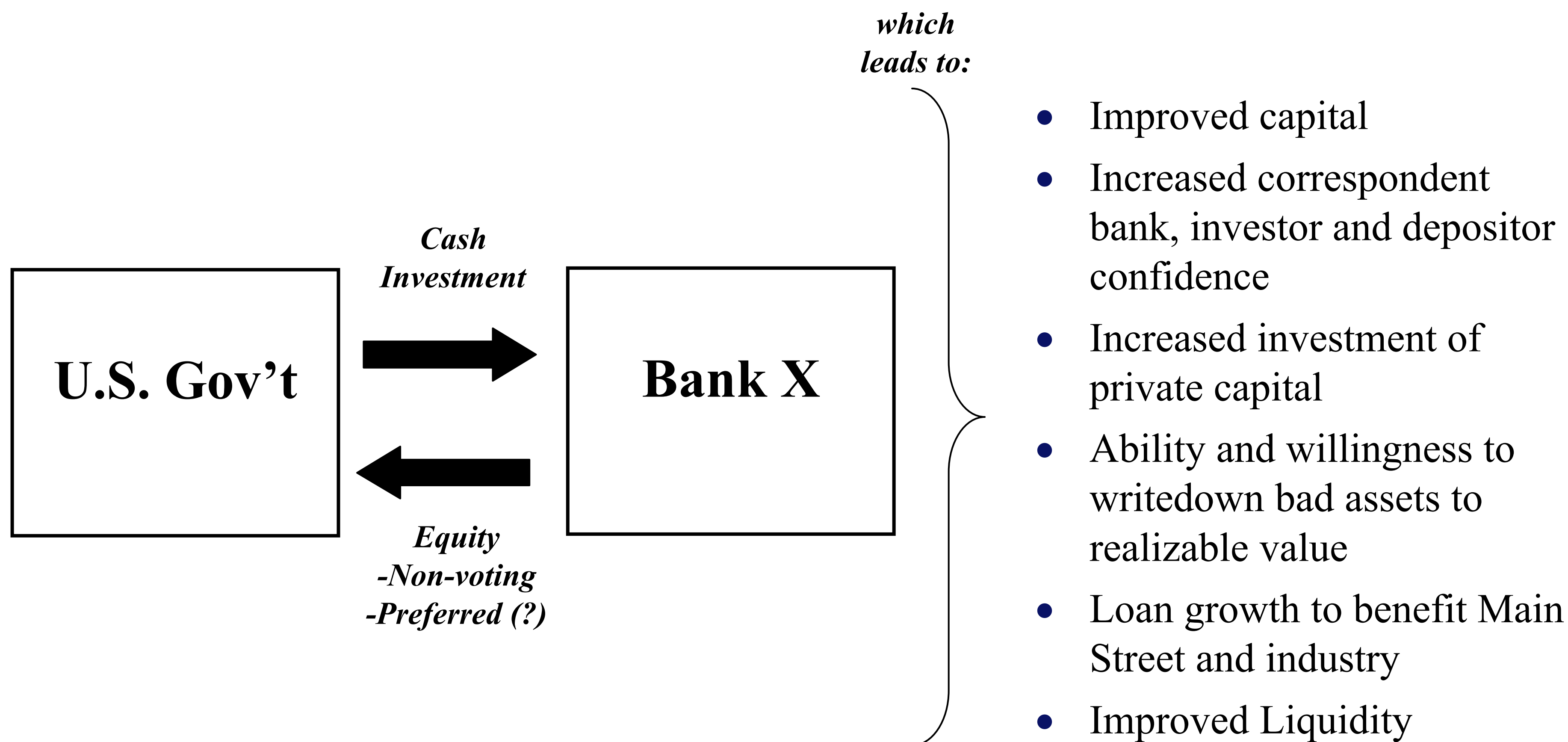
- ***In our October 7 presentation, "TARP and EESA: What is it and What does it Mean to Community Banks," we concluded, among other things, that:***
  - The Treasury has failed to convince investors, depositors and other banks that TARP will break the back of the banking crisis—they are concerned not just about liquidity but solvency and capital
  - TARP does not inject capital into the banking system to fill up the capital hole resulting from sales of mortgage related assets to the TARP fund
  - Capital must come from a combination of private investors, other banks, and the government
  - TARP's auction and guarantee processes will take too much time to implement which will limit their effectiveness
  - TARP is largely a Wall Street bailout, not a community bank bailout

Conclusions of Treasury Post-Enactment of EESA

- The Treasury has reluctantly concluded that:
  - The principal mechanism of EESA – an auction process to purchase bad mortgage related assets to create liquidity is still weeks away from implementation
  - The current auction and guarantee programs only address bank liquidity issues and do not address concerns about solvency and the need for capital
  - The Treasury must inject capital directly into banks and other financial institutions
- The Treasury believes it currently has the authority to make equity investments in banks and other financial institutions because they are "troubled assets"
  - The Treasury, in consultation with the Federal Reserve, may determine that a "***troubled asset***" includes "***<u>any other financial instrument… the purchase of which is necessary to promote financial market stability</u>***." A report must be made to the appropriate Congressional committees if instruments are purchased under this provision
  - Statements by the President and members of Congress appear to be consistent with the Treasury's position
  - The position of the Treasury is not free from legal doubt

Direct Investment in Financial Institutions

- ***Paulson***: *The U.S. will purchase equity in a "broad array" of banks and other financial firms to restore market stability and ensure economic growth*



Questions about Direct Investment

- When will the government begin making direct investments in financial institutions?
  - *Paulson:* As soon as possible (probably within next 7-10 days)
- Which institutions will be eligible to receive direct investment?
  - *Paulson*: "a broad array of financial institutions"
    - Includes investment banks, insurance companies and is rumored to include hedge funds
  - *Large vs. Small?*
    - G-7 has emphasized investment in "systemically important financial institutions" so they do not fail
    - The UK will take significant equity stakes in HBOS, RBS and Lloyds
    - France and Germany will make significant equity injections into banks
    - Goldman, Morgan Stanley and Nat City are rumored to be on top of the list
  - *"Stressed" vs. "FDIC Watchlist" vs. "Near-Stressed" vs. "Healthy"?*
    - The Treasury met with several banks and investment firms about government investment last week and, amid concerns about restrictions on executive compensation, the Treasury has made it clear that such restrictions will be lenient when applied to a set of "healthy" companies
    - Government's direct investment will probably be designed to complement the efforts of banks to raise fresh capital from private sources—*Chicken or Egg Question*—will investors deploy private capital in "stressed" institutions or institutions which are on the brink of failure?
    - *Will investments be made by CAMELS rating*? BIG QUESTION: Will the Treasury permit the weakest institutions to fail or assist the weakest banks first?

Questions about Direct Investment *(cont'd)*

- **How will the government administer and apply the direct investment program?**
  - *Paulson: "A standardized program"*
  - *Will private investment be a prerequisite? Unclear, but it does appear whatever is finally adopted will try to encourage (or at least not discourage) private investment*
  - *How will the government price its investment?*
    - Price established via private investment?
    - Stated TBV or Real TBV after writedowns?
  - *What form of security will the government hold?*
    - *Paulson:* Non-voting
    - Preferred or Common—if preferred, Tier 1 or Tier 2 Capital?
    - Will the government be entitled to board representation or observer rights? Treasury has quietly questioned how it will protect its investment
    - Will government investment pre-empt state law and institutions' organic documents regarding shareholder meetings and authorization of number and class of securities?

- **Will direct investment in some institutions cause destabilization of, or competitively disadvantage, other institutions?**
  - *Investment may serve as a federal endorsement of the recipient of the direct investment*
  - ***Will government investment trigger cause a transfer of deposits and other customer relationships away from institutions which do not receive government investment?***
  - ***Will propping up some banks (especially large banks) further tilt the competitive landscape between big banks and smaller banks and among banks of all sizes in discrete geographic markets?***

Other Government Actions

- Federal regulators directed Freddie and Fannie to begin purchasing $40 billion of subprime, Alt-A and non-performing prime mortgage securities per month
  - Purchases are separate and outside of EESA
  - *"The overall goal of the program will be to contribute greater stability and liquidity in the mortgage market, which should enhance consumers' access to mortgage financing and ultimately result in reduced mortgage rates" ---FHFA Director*
  - These purchases by Freddie and Fannie should permit the Treasury to allocate a greater share of the $700 billion comprising TARP to direct equity investments in banks and other financial institutions
- Federal regulators instructed Fannie Mae to purchase mortgages from FHLBs in order to provide FHLBs with capital and to provide funding to their member banks to originate mortgages
- The Federal Reserve created the Commercial Paper Funding Facility which will provide a liquidity backstop to U.S. issuers of commercial paper through a special purpose vehicle by purchasing 3-month unsecured and asset-backed commercial paper directly from issuers
- As part of a global coordinated effort, the Federal Reserve cut the federal funds rate by 50 bps to 1.5%. It is expected that rates will be cut again before the end of the year
- In tandem, European central banks said they would lend out as much U.S. dollar liquidity as banks need
- The Federal Reserve, the European Central Bank, the Bank of England and the Swiss National Bank said they would meet all bids from banks at a fixed interest rate

Other Proposals Being Considered

- Temporary guarantee of all bank deposits
  - Reports have indicated that the Treasury is considering removing the limit on insurance for bank deposits without any additional cost to banks, thrifts and credit unions for insuring such excess deposits
- Reported proposal to guarantee all interbank lending
  - Such a program would be designed to enable banks to lend to one another on a risk free basis
  - Germany, France and the EU have adopted a program to guarantee interbank lending until the end of 2009
    - The EU will go further and provide a guarantee of all new medium term (up to 5 years) bank senior debt issuance
- Stimulus package for State and Local Governments
  - Reports regarding the current proposal would include tax relief in some form for families, extending unemployment insurance benefits beyond 39 weeks and expand the food stamp program
  - Additionally, as much as $150 billion would go to states and cities to sustain their everyday spending
  - Rationale: While the nearly $1 trillion that Congress and the Federal Reserve are making available to the financial system is intended to make credit available (supply), this stimulus package is designed to increase demand (and stop spending from further contracting)
    - State and local spending account for 12% of the U.S.'s economic activity, and there is widespread contraction in their spending because of lower revenues and laws that require them to balance their budgets

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