



## Policy & Regulation

### How the US financial bailout works

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**The huge financial rescue bill enacted by Congress on October 3 authorizes the United States Treasury to purchase or guarantee up to US\$700 billion of so-called toxic securities held by eligible financial institutions in order to provide liquidity and stability to the US financial system.**

Using authority granted in the bailout bill, US Treasury Secretary Henry Paulson said Tuesday the American government would put as much as US\$250 billion into banks, and get equity stakes in return - following similar rescue packages announced across Europe on Monday.

**Marc Alpert** and **Kessar Nashat** from **Chadbourne & Parke** in New York examine the "troubled asset relief program" (TARP) and explain what qualifies for purchase and from whom.

#### Purchases of Troubled Assets

Troubled assets eligible for purchase consist of two types.

One asset class is residential and commercial mortgages and any securities, obligations or other instruments based on or related to these mortgages, in each case originated or issued on or before March 14, 2008, if the Treasury Secretary determines that their purchase would promote financial market stability.

The other class is any other financial instrument whose purchase the Treasury secretary, after consultation with the chairman of the Federal Reserve, determines is necessary to promote financial market stability.

Troubled assets generally can be purchased only from financial institutions that are established and regulated under the laws of the United States and its territories and that have significant US operations, and not from central banks of, or institutions owned by, foreign governments.

However, there is an exception. The Treasury may purchase troubled assets held by foreign financial authorities or central banks if the troubled assets are held as a result of extending financing to US financial institutions that have failed or defaulted on that financing.

The Treasury has broad discretion for how to buy assets.

In general, it is supposed to use market mechanisms, including auctions or reverse auctions, where appropriate. However, if the Treasury decides that use of an auction is not feasible or appropriate, it has authority to make direct purchases, subject to safeguards to ensure the prices paid for troubled assets are reasonable and reflect the underlying value of the assets.

Among other restrictions, the Treasury cannot pay more for an asset than the seller paid to purchase it.

The Treasury has been given six weeks to work out all the details. It must publish guidelines by November 17, 2008. The guidelines will explain how it plans to purchase assets, identify what types of assets will be purchased and how they will be valued.

Everything will be done in full view of the public. Within two business days of each purchase, the Treasury will be required to make public in electronic form a description of each asset purchased and the price paid.

The Treasury has been given other tools besides buying toxic assets.

It has also been authorized to run an insurance program that will guarantee future payments on troubled assets that were originated or issued before March 14, 2008. This is an alternative to making asset purchases. Any guarantees would cover up to 100 per cent of principal and interest on troubled assets with terms and conditions to be set by the Treasury.

If the government chooses this approach, then it would collect premiums tied to the credit risk associated with the guaranteed assets. Premiums would be set at a level needed to create reserves sufficient to meet anticipated claims.

This insurance alternative was put in the rescue bill at the urging of House Republicans. Paulson is skeptical about whether such an approach would provide any benefit, since it would require the financial institutions themselves to bear the cost of the bailout. He is not expected to use it.

## **Warrants**

Participating financial institutions that sell assets must issue the US government warrants to buy stock or a senior note.

The idea is to reduce the odds the US government will lose money on the toxic assets since the government can profit from any appreciation in share value in the financial institution or be assured of repayment of some amount on a note.

Financial institutions that are publicly traded in the United States must issue the government warrants for nonvoting common or preferred stock (or voting stock if the Treasury agrees not to exercise voting power).

Other financial institutions must issue the government warrants for common or preferred stock or give the government a senior debt instrument bearing a reasonable interest rate.

Any warrant issued must provide for reasonable participation in equity appreciation, be convertible into senior debt or contain protections to ensure the Treasury is appropriately compensated for the warrant if the financial institution ceases to be publicly traded in the United States. It must also contain anti-dilution provisions to protect the value of the warrants from stock splits, stock distributions, dividends, other distributions, mergers, reorganizations and recapitalizations.

No warrants or notes need be issued if the total amount of all troubled assets sold by a financial institution to the Treasury is below a minimum to be established by the Treasury. Treasury cannot set the minimum any higher than US\$100 million.

## **Spending Limits**

Although press reports put the cost of the bailout bill at US\$700 billion, the Treasury has only been authorized to spend up to US\$250 billion initially.

It must cross two speed bumps on the way to the full US\$700 billion.

The Treasury will get an additional US\$100 billion if the president certifies to Congress that the Treasury needs the additional money. The president can raise the amount by another US\$350 billion - to US\$700 billion in total - by sending Congress a report explaining in detail how the Treasury plans to spend the increased authority.

Congress will have 15 days after receiving the report to reject the additional spending plan. Otherwise, the plan is considered automatically accepted.

Any insurance issued will count against the spending limits.

The authority to purchase or guarantee troubled assets will end on December 31, 2009. However, the Treasury can get an extension to October 2, 2010 by sending a report to Congress explaining why the program should be extended and how much the extension will cost.

Commitments issued before the deadline to purchase or guarantee assets will be honored. The deadline applies only to purchases and guarantees. It is not a time limit on how long the government can hold the assets it purchases. The idea is for the government to resell them eventually once the market recovers.

Congress did not want the government to lose money on the program. However, it was vague about how to avoid a loss. The Office of Management and Budget must send a report to Congress at the five-year mark explaining how much the program has cost.

Whoever is president at the time must then send a proposal to Congress for how to make up any shortfall from the financial industry.

### **Pay Limits**

Financial institutions that sell assets to the Treasury will be subject to limits on how much they can pay their top five executives.

Any institution that makes a direct sale of assets to the Treasury without going through an auction and that gives the government a "meaningful" equity or debt position in the financial institution must meet "appropriate standards for executive compensation and corporate governance" for as long as the US government holds an equity or debt position.

These standards will include the following:

- Bonuses and other pay cannot be structured in a way that encourages senior executives to take unnecessary and excessive risks that might threaten the value of the financial institution.

- The institution must reserve the right to claw back pay that is based on financial performance metrics that are later materially restated.

- Senior executives cannot receive golden parachute payments while the government holds a stake in the company.

The restrictions on executive pay are less stringent where the government buys troubled assets in an auction. In that case, the financial institution is prohibited only from entering into

any new employment contract with a senior executive that provides for a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency or receivership.

This restriction is triggered when the troubled asset purchases from the institution reach US\$300 million (including direct purchases).

Senior executive is defined for purposes of these restrictions as one of the top five executives of a public company whose compensation is required to be disclosed under US securities rules and the non-public company counterparts of these individuals.

That means the CEO, CFO and the three other highest compensated officers.

The Treasury has also been directed to determine, for each class of financial institution that sells troubled assets to the government, whether the public disclosure required of off-balance sheet transactions, derivative instruments, contingent liabilities and similar sources of potential exposure is adequate to provide the public with a clear picture of the true financial position of the institution.

### **Avoiding Foreclosures**

The Democrats in Congress insisted on relief for homeowners at the other end of the mortgages that the government will be purchasing.

The Treasury is required to implement a plan encouraging the use of an existing program called the HOPE for Homeowners Program to modify terms to avoid foreclosures on mortgages tied to residential real estate.

The Treasury has also been authorized to use loan guarantees and credit enhancements to facilitate loan modifications.

The government must consent, where appropriate and taking into account the net present value cost to taxpayers, to reasonable requests for loss mitigation measures, including term extensions, interest rate reductions and loan principal reductions.

### **Tax Provisions**

The rescue bill makes a number of tax changes that should help implement the program.

Banks and certain other financial institutions that held Fannie Mae or Freddie Mac preferred stock on September 6, 2008 and later sell the stock, or that sold such stock in 2008 on or before that date, will recognize ordinary income or loss for US federal income tax purposes rather than capital gain or loss.

The tax deduction for compensation paid by companies selling assets to the government will be limited to US\$500,000 for each of the company's top five executives.

However, this limit only applies to companies that sell more than US\$300 million in troubled assets unless the company's only sales of troubled assets are direct sales to the Treasury.

Once the deduction limit comes into play, it will continue to apply to that executive as long as the TARP program remains in effect, and even after that date for deferred compensation attributable to that period.

Severance paid to the top five executives of companies subject to the US\$500,000 limit on compensation deductions will be treated as golden parachutes if the executive is terminated involuntarily or in connection with any bankruptcy, liquidation or receivership of the company.

That means that a large part of the severance will not be deductible. It will also be subject to a 20 per cent non-deductible excise tax payable by the executive if the amount of the severance payments to that executive equals or exceeds three times a base amount (generally the executive's average compensation over the last five years). If the severance equals or exceeds three times the base amount, the deduction disallowance and excise tax apply to any severance payment that exceeds one times the base amount.

The rescue bill also extended through 2012 an exclusion from income for discharges of qualified principal residence indebtedness.

### **Other Provisions**

The standard maximum deposit amount insured by the government through the Federal Deposit Insurance Corporation and the National Credit Union Share Insurance Fund will be temporarily increased from US\$100,000 to US\$250,000 beginning October 3, 2008 and ending on December 31, 2009.

Actions taken by the Treasury under the bill will be subject to judicial review, but will be set aside only if found to be arbitrary, capricious, an abuse of discretion or not in accordance with law.

Provisions contained in existing or future standstill, confidentiality or other agreements that affect or limit the ability of any person to acquire all or part of any insured depository institution in connection with any transaction in which the FDIC exercises certain of its powers will not be enforceable against that person.

To address the problem of mark-to-market accounting when there is no longer a market for a held asset, the rescue bill allows the US Securities and Exchange Commission to suspend the application of FASB Statement No. 157 (prescribing mark-to-market accounting in determining the fair value of certain assets).

On September 30, the SEC and FASB issued a press release providing clarifications intended to help companies, auditors and investors address some of the more urgent fair value measurement questions that have been raised and indicating that the FASB is preparing additional interpretative guidance.

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