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Special Report:

Financial Stability Plan and the 2010 Midterm Election

SPECIAL REPORT: The Financial Stability Plan and the 2010 Midterm Election

Perhaps the most significant efforts of the first months of the Obama Administration will be its programs to return stability to the financial markets. Unkindly referred to by most as “bailouts,” they are officially known as the “Financial Stability Plan.” Interestingly, the breadth, scope, and perceived success or failure of the Obama Administration’s plans -- adopting, continuing and expanding upon those of the Bush Administration-- certainly has a chance of being a major issue of the 2010 congressional elections.

Question: If the Administration’s plans do not work, will Congress pay for it in the next election?

Voters and the press look to the government for “silver bullet” solutions, and programs that do not provide them are viewed as failures.

Evolution of the Financial Stability Plan:

Congress passed the Emergency Economic Stabilization Act (“EESA”) in October, 2008 and under it Treasury created the Troubled Asset Purchase Program (“TARP”), with the stated goal of purchasing toxic assets from banks. Before a single asset was purchased the original goal was abandoned in favor of the government directly injecting capital into the financial institutions under a Capital Purchase Plan (“CPP”). When it became clear that simply shoring up the capital positions of banks was insufficient to ride out the crisis, the government policy returned to the disposition of assets carrying depressed valuations.

Of course, government injection of capital into the banks undoubtedly prevented some of them from failing, avoiding the adverse impact that would have had on public confidence in the financial markets and the economy. That alone, in less trying times, might have been enough to categorize the effort as a success, but these are more trying times. A government “bailout” of the banks was not welcomed by voters then or ever since.

As events have transpired, whether by plan or by trial and error, component parts of a plan are evolving to attempt to accomplish the original goals of cleaning up bank balance sheets, their recapitalization, and returning liquidity to the credit markets. The pattern is a repeating one: the first step is a Federal Reserve Board initiative, followed by a Treasury program expanding the effort. Critically, in each case, the need to go back to Congress has been avoided.

CPP and CAP

For example, in February, 2009, Treasury announced the CPP was morphing into the Capital Assistance Plan (“CAP”). Banks issue convertible preferred stock to the Treasury which will either be bought back by the institution in seven years or less, or it will convert the government from preferred to common stockholder. Perpetual preferred issued by banks under the CPP can be converted to convertible preferred under the CAP. The CAP is designed to create an incentive for the institution to raise private capital and buy out the interest of the government. CAP has generally been viewed as a satisfactory evolution of CPP because it includes an exit strategy for using private capital to repay the government, and because it

addresses consumer outrage by limiting compensation, bonuses and dividends paid by institutions taking TARP funds.

TALF

The second part of the CAP is an expansion of the Term Asset-Backed Securities Loan Facility (TALF). A Treasury program being run in coordination with and by the New York Fed, the TALF initially will receive securities backed by automobile loans, credit card receivables, student loans, small business loans, and it is ultimately hoped, commercial mortgage backed securities. Treasury has announced that the TALF is an integrated part of the Public Private Investment Program (discussed below) and will be expanded to include non-agency residential mortgage backed securities and possibly even certain types of corporate debt.

It should be noted that it was a Federal Reserve initiative, not Congressional action, that took the first steps to provide liquidity to these key credit markets. The Federal Reserve created a Commercial Paper Funding Facility, an Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, and the Money Market Investor Funding Facility on its own volition to ease problems in those markets. Watching the relative success of these programs, they are now teaming with Treasury to support an expansion of TALF to do more.

It remains to be seen, however, whether the TALF is successful, or more important for the Administration, whether it will be perceived as working. The first TALF subscription attracted \$4.7 billion in requests for loans. The second subscription attracted only \$1.7 billion. All of the securities submitted were backed by auto loans and credit card receivables, not the politically important student loans, small business loans or commercial mortgages. Still a

work in progress, we expect to see the terms of TALF tweaked to attract more participation. The Federal Reserve has already indicated that they are considering extending the term of certain TALF loans from three to five years.

GSEs as Government Agencies

Similarly, the Treasury has been more or less directly injecting funds into the mortgage markets by using its conservatorship powers over Fannie Mae and Freddie Mac and by directly purchasing over \$100 billion of Fannie and Freddie mortgage backed securities itself. Essentially, the government sponsored enterprises have been returned to the status of government agencies that disburse funds to accomplish a public policy purpose without regard to profitability that their technically private status would demand, and importantly, without the need for further Congressional approval of up to \$400 billion. Treasury is making a total of \$400 billion (\$200 billion of each company) of capital support available to them to support the mortgage purchase activities their own dwindling capital would not allow. Their efforts have helped ease the crunch of credit in the mortgage markets, lowered mortgage interest rates and provided taxpayers the opportunity to save money by refinancing.

As in the commercial paper market, the effort of Treasury in providing capital to the GSEs is actually the evolution of a Federal Reserve model. The Fed program to encourage mortgage market liquidity involved using its own balance sheet to buy mortgage backed securities and the debt of Fannie Mae and Freddie Mac. The rescue program pattern is repeated: the Fed initiates, and if the program seems to get traction, the Treasury expands it. In this case, using the balance sheets of two official and two de facto government agencies.

PPIP

The most recent effort is the Public-Private Investment Program (“PPIP”). Economists, investors, regulators and Congress agree that “legacy” “toxic” assets and loans on the books of banks are the problem. That is why Congress approved legislation providing over \$700 billion to allow the Treasury to buy the toxic assets in the EESA. The PPIP is the first program to actually attempt to accomplish that goal.

The terms of the PPIP at this point are public and thoroughly vetted, pro and con, in the press. In brief, the PPIP calls for using a combination of public and private money to encourage investors to participate in auctions and buy from \$500 billion to \$1 trillion in toxic assets from banks. Investment funds will be created by private sector managers who will raise private capital that will be matched by Treasury. Each fund manager will have the option to obtain non-recourse loans from Treasury in an aggregate amount of up to 50% of a fund’s total equity capital to provide leverage. Treasury will receive half of the equity and protective warrants.

If the asset ultimately rises in value, most of the gain goes to the investor, if the asset loses all of its value, all the loss goes to the taxpayer. Some have questioned whether the public participation is a fig leaf to cover the implementation of the original plan of the TARP, government purchase of toxic assets.

The PPIP program will take some time to implement. Prospective dealers must apply by April 24th and will be notified if they are chosen by May 15th. Once chosen, the dealers will need time to raise \$500 million of private capital. The first auctions presumably could occur no sooner than June. The fact this will be in the

summer with usually dull markets may or may not matter. Nor will it matter much to Congress which is out part of July and all of August. No one knows whether the PPIP will be successful or not. The Chairman of the Board of JP Morgan Chase, Jamie Dimon, quite conspicuously announced that his institution would not participate in the program. Issues remain concerning whether banks will be willing to sell assets for less than they are carried on their books, realizing an immediate loss and capital reduction. Whether regulators will force such sales is also a question. One thing is clear, the Administration has a great deal at stake in the success or failure of the PPIP. The reason: According to the Congressional Oversight Panel, discussed below, the \$700 billion baseline expenditure of the EESA to address this problem has been overwhelmed by over \$2 trillion in spending by the Federal Reserve Board and \$1.4 trillion in spending (in the form of guarantees of newly issued bank debt) by the Federal Deposit Insurance Corporation.

Congress, the Administration and the Federal Reserve:

With the end of the congressional summer break, however, legislative and political attention turns to the fact that the end of the first session of 111th Congress will be approaching. The second year of a Congress is fixated on the campaign and ends in an election. The pronouncements being made by Fed Chairman Bernanke and others about how the economy will stabilize and the recession will end in the fourth quarter evidence the hopes of the political community as well as the financial one.

Suppose the economy does not improve significantly and the perception if not the reality is that despite in excess of \$4 trillion

having been committed to the stability plan, the Administration's programs are not working. Should Congress be worried?

With the exception of passing a bill authorizing a much smaller amount of money to be spent than creative agencies have spent on the issue, Congress has not been a major part of the details of the financial stability program. Politically, however, if it does not work, Members of Congress and Senators stand a good chance that they will pay the price in 2010. The Federal Reserve Board Chairman does not run for election (although Bernanke's term expires in 2010 and admittedly, his reappointment may be in the balance) and neither does the Treasury Secretary (although several former Treasury Secretaries have been forced out by a sitting President). All 435 members of the House and one third of the Senate are up for re-election and it is they who have to answer questions about "bailing out the banks" to their constituents.

With the impact of the PPIP and other components of the Financial Stability Plan conclusively collectively coalescing or not somewhere around the opening of the election season, members of both parties may be looking for a way to distance themselves from the Administration if the collective plans do not work.

When it comes to protecting themselves, Congress demonstrates substantial political foresight. In this case the safety valve involves tasking someone else with responsibility for overseeing the financial stability program. Congress has provided for oversight in the form of reports and recommendations to be made by the: (1) Federal Reserve Chairman (upon consultation with Treasury Secretary); (2) Financial Stability Oversight Board (consists of various agency heads); (3) GAO (Government

Accountability Office); (4) Special Inspector General for the Troubled Asset Relief Program (SIGTARP); (5) Congressional Oversight Panel; (6) Office of Management and Budget and the Congressional Budget Office; and (7) President of the United States (through his annual budget submission to Congress). Though the GAO and SIGTARP have offered some criticism of the Financial Stability Plan as to its transparency and accountability through their reports and Congressional testimony, the strongest foundation for Congress avoiding responsibility for the acts of the Administration was recently delivered to them in the April Oversight Report of the Congressional Oversight Panel ("COP Report"). That panel is chaired by the congressionally appointed Harvard Law Professor Elizabeth Warren.

First, it is not lost on the press or anyone else that the Administration has executed a run around Congress and the appropriations process to fund their relief programs. As noted in the COP Report:

In addition to drawing on the \$700 billion allocated to Treasury under the Emergency Economic Stabilization Act (EESA), economic stabilization efforts have depended heavily on the use of the Federal Reserve Board's balance sheet. This approach has permitted Treasury to leverage TARP funds well beyond the funds appropriated by Congress. Thus, while Treasury has spent or committed \$590.4 billion of TARP funds, according to [Congressional Oversight] Panel estimates, the Federal Reserve Board has expanded its balance sheet by more than \$1.5 trillion in loans and purchases of government-sponsored enterprise (GSE) securities. The total value of all direct spending, loans and guarantees provided to date in conjunction with the federal government's financial stability efforts (including those of the Federal Deposit Insurance Corporation

(FDIC) as well as Treasury and the Federal Reserve Board) now exceeds \$4 trillion....

The COP Report is a not so thinly veiled criticism of the strategy or lack thereof of the current Administration. Note the Congress provided oversight of the original \$700 billion program in the form of the monthly reporting Congressional Oversight Panel. Most of that money has been spent, and indeed, some of the recipients already want to give it back to the government. The Congressional aspect of the financial stability effort has not failed. It is Treasury and the Fed who are acting on their own and dramatically increasing the amounts put to the effort. This has been done without their needing to secure additional congressional authorizations by virtue of their “independence” and unique authority. Presumably, this supports the conclusion that if the programs fail, it was not the fault of Congress.

In case that point was missed, the COP Report makes it clear the panel is not in agreement with the abandonment of the traditional way of resolving bank failures (i.e., liquidation and firing of the officers). The COP report states:

Treasury’s approach fails to acknowledge the depth of the current downturn and the degree to which the low valuation of troubled assets accurately reflects their worth. The actions undertaken by Treasury, the Federal Reserve Board and the FDIC are unprecedented. But if the economic crisis is deeper than anticipated, it is possible that Treasury will need to take very different actions in order to restore financial stability.

Note the last line, it is Treasury that will need to take actions. The congressional overseer and protector is telling the Administration not to

expect the Congress to pass an expensive bill, close to an election, bailing out the failed Treasury promoted programs.

This is not the first time that friction has appeared between the Fed, Treasury and the congressionally appointed overseer of the TARP program. On April 1, 2009 responding to a March 20th inquiry from COP Chair Elizabeth Warren about the seeming lack of success, Federal Reserve Chairman Ben Bernanke and New York Fed President William Dudley jointly defended the TALF program:

Results from the TALF’s first subscription showed a substantial decline in funding costs for the auto and credit card issuers that came to market,” the Fed officials wrote. “If sustained, this should translate to lower credit card and auto loan rates for consumers.” Additionally, they said the program has appropriate safeguards to protect taxpayers and added that without the facility, continued strains on credit could further weaken the economy.

We suspect this will not be the last confrontation between the Treasury, the Federal Reserve and the COP. In fact, the Special Inspector General for TARP (SIGTARP) will issue its second report to Congress on April 20, 2009 to “detail additional recommendations to Treasury to avoid waste, fraud and abuse in the recently announced TARP programs, and provide Congress with a status report on the implementation of its previous [accountability and transparency] recommendations.” As the campaign and election nears, if the programs have not succeeded in revitalizing the financial services sector, we look to hear more than a few shrill cries from Congress and its advisors.

Success vs. Failure: The Voter Ultimately Decides

What constitutes “successful” policy and what is “failed” policy is already being argued by economists, politicians, and the financial community. Ultimately, however, the judge will be the voter. It is their reaction that may hinge less on the details of the programs being implemented and more on how the public perceptions of success and failure are molded. Voters are more likely to judge the results of these policies based on unemployment levels, foreclosure numbers, home values, and inflationary pressures than on the capital position of banks. In addition, the public will likely judge success by the press reports on the compensation practices of the beneficiaries of the taxpayers’ largess, and perceived profiteering by the government’s private sector partners.

The Administration and its Congressional supporters have both an epic policy and epic marketing challenge. Time and elections ultimately will dictate “success” or “failure” of the Financial Stability Plan.

Williams & Jensen is closely following political developments surrounding the construction and implementation of the Administration’s Financial Stability Plan. This Special Report will be followed by others, evaluating the progress of the Financial Stability Plan and its impact on the economy, the markets, the political environment and election. We encourage you to contact us if we may be of assistance.

For more information you may contact us at 202-659-8201 or email us through the links below.

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