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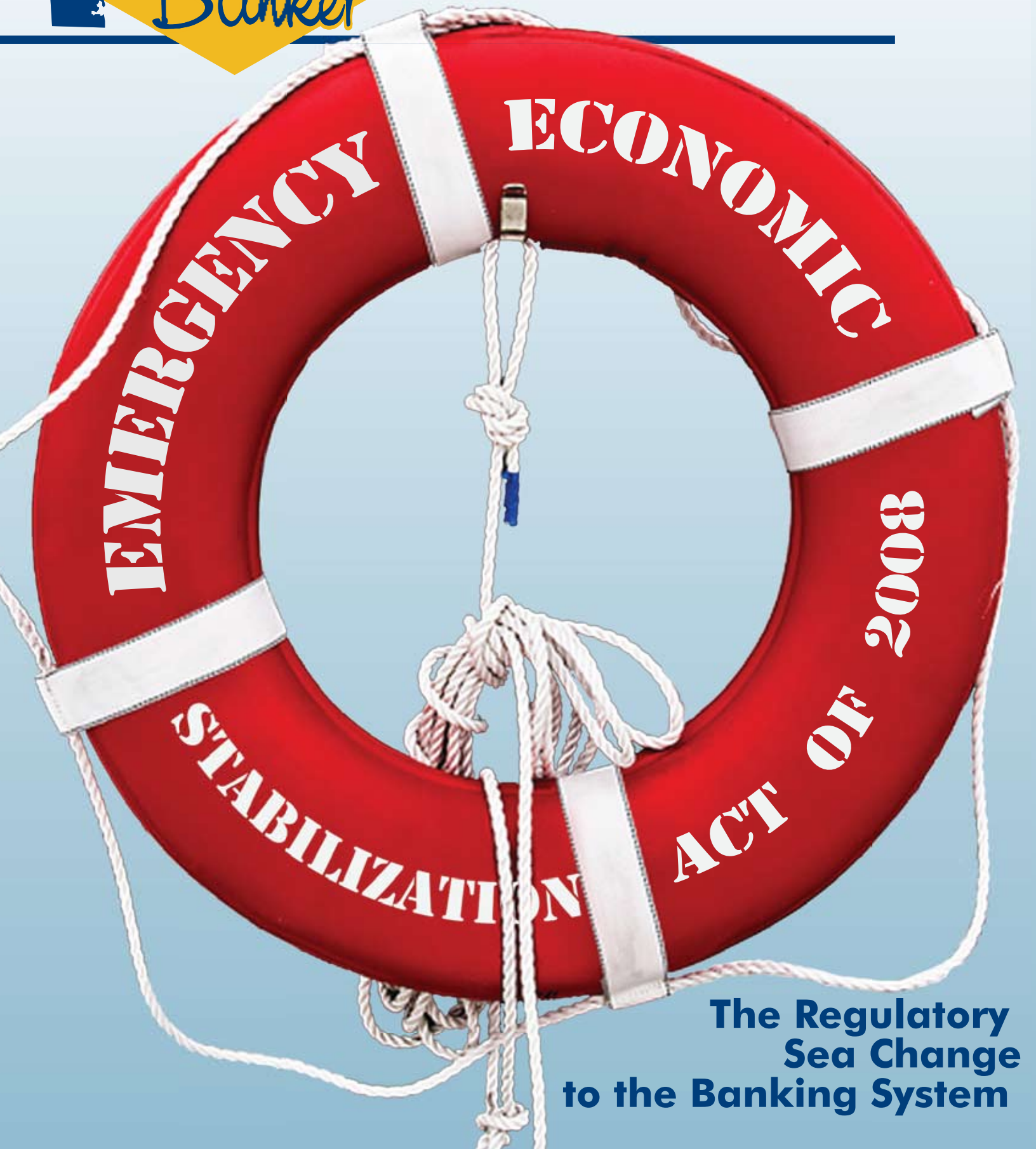

The Regulatory Sea Change to the Banking System

The Troubled Asset Relief Program

Observations from a bank regulatory perspective on the Emergency Economic Stabilization Act of 2008

Help on the way? What are the regulatory implications?

by
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On October 3, of 2008, the President signed into law, following a brief bout of Congressional defiance, the Emergency Economic Stabilization Act of 2008 (the "Act") which has as its core the Troubled Asset Relief Program, or TARP. The Act will, among other things, "immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States." Section 2. Once implemented, the hope is that TARP will free up what Senator Dodd of Connecticut, Chair of the Senate Banking Committee, describes as "a wall of capital" that the banking system is poised to unleash on the economy, and restore beleaguered world and public confidence in our Nation's bank savings and capital markets. This article begins with a summary of the salient provisions of the Act, but that is not its principal purpose. Rather, your authors choose to focus on the regulatory sea change in the United States banking system wrought by both the Act and the unprecedented interventions and dispensations by the Treasury and the Federal Reserve Board that antedate its passage, hopefully with the goal of gleaning what we can at this nascent stage of the rescue effort about the future of bank regulation in these United States.

SUMMARY OF THE EESA of 2008

1**. General Provisions -** The Act grants the Secretary of the Treasury (the "Secretary") authority to purchase up to $700 billion of troubled assets under the Troubled Asset Relief Program ("TARP"). The legislation establishes a graduated series of tranches to utilize the $700 billion. The Act grants the Secretary the authority to spend $250 billion immediately. The President may increase the limit to $350 billion at any time by submitting a written certification to Congress. Authority to spend the final $350 billion goes into effect if the President submits to Congress a written report detailing the Secretary's plan to spend it, unless Congress disapproves the plan by joint resolution. Section 115. The Secretary's authority under TARP expires on December 31, 2009.

The Act gives the Secretary extensive authority to use TARP to purchase a broad range of assets from a multitude of financial institutions. The Secretary has the authority to purchase, and to make and fund commitments to purchase "troubled assets" from any "financial institution." Section 101. The definition of "troubled assets" is liberally defined to include "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages that were originated or issued before March 14, 2008." Additionally, the Secretary has the authority to purchase any other financial instrument that the Secretary, in consultation with the Chairman of the Federal Reserve, deems "necessary to promote financial market stability." Section 3. The Act defines "financial institution" with an equally broad brush to include "any institution, including but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any State…and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government." Section 3.

The Secretary must implement the program through the newly created Office of Financial Stability. The Secretary may take any action he deems necessary to carry out the provisions of TARP, including designating financial institutions as agents of the federal government and establishing vehicles authorized to purchase, hold, and sell troubled assets and issue obligations. Section 101. The Act provides a general framework to the Secretary to determine how and which assets to purchase and how to price troubled assets. The Secretary must consider the interests of the taxpayers, the impact

on national debt, the stability of financial markets, the preservation of homeownership, the needs of all financial institutions, the needs of local communities and the long-term viability of an institution in determining whether to purchase assets under TARP. Section 103. With respect to pricing, while the Secretary is required to prevent unjust enrichment of financial institutions, the Secretary is simply directed to make purchases under TARP at the lowest price he determines to be consistent with the purposes of the statute. Section 101. The Secretary has the authority to manage troubled assets, including the ability to dispose of the assets. Section 106.

2. Protections for the Federal Government and Taxpayers - The Act provides a number of protections for the federal government and taxpayers with respect to the purchase of assets and the protection against mortgage foreclosure. The Secretary may not purchase troubled assets from a financial institution unless the federal government receives stock warrants or senior debt instruments in financial institutions with limited exceptions for those institutions with less than $100 million in troubled assets. Section 113. The Secretary is also required to establish an insurance program to guarantee troubled assets of financial institutions and to establish risk-based premiums sufficient to cover anticipated claims. Section 102. The Act also imposes some constraints on executive compensation for those financial institutions participating in TARP. Section 111. Additionally, the profits realized from the sale of troubled assets must be used to pay down the national debt. Section 106.

A number of homeowner protections are also provided in the Act. For mortgages and mortgage-backed securities acquired through TARP, the Secretary must implement a plan to mitigate foreclosures and encourage mortgages through the Hope for Homeowners and other programs. Section 109. The Act also requires federal regulatory authorities to develop plans to minimize foreclosures. Section 110. Finally, the Act provides broader consumer protections by temporarily increasing FDIC insurance and National Credit Union Share Insurance limits from $100,000 per account to $250,000 until December 31, 2009. Section 136.

3. Oversight and Reporting - While the Act grants the Secretary fairly broad discretion with respect to the purchase of troubled assets from financial institutions, it also sets forth several oversight and reporting mechanisms to monitor the Secretary's activities. The Act vests principal oversight responsibility in the Comptroller General and requires the Comptroller General to report every 60 days to Congress on the performance of TARP. The Comptroller General is also required to conduct an annual audit of TARP. Section 116.

The Act also establishes the Financial Stability Oversight Board ("FSOB") to review and make recommendations regarding the Secretary's exercise of authority under TARP. The FSOB must submit quarterly reports to Congress. Section 104. The Act also establishes the Office of the Inspector General for the Troubled Asset Relief Program which is responsible for conducting audits and investigations of the activities of the Secretary. The Special Inspector General is appointed by the President with the advice and consent of the Senate. As with the FSOB, the Special Inspector General must also submit quarterly reports to Congress. Section 121.

In addition to this oversight, the Secretary is required to submit monthly reports to Congress, including detailed financial statements. The Secretary must also provide Congress with tranche reports for every $50 billion in assets purchased. The Secretary must make available to the public a description, including amounts and pricing, of the assets acquired under TARP. Section 105.

REGULATORY LESSONS: SOME PRELIMINARY OBSERVATIONS

As we cautiously await the impact of the capital-generating and asset acquisition provisions of the Act, there is still much that we do not yet understand about the blend of factors that brought the financial sector to its knees, or what prescriptive measures will best and most quickly offer a cure. But, from a regulatory perspective, some observations appear:

1. Remember when, in 1984, the Federal Reserve Board designated 11 large banks as "too big to fail"? What was then primarily an academic exercise, and one that faded into relative obscurity (although from time to time in the ensuing years it arguably effected their cost of borrowing), is now an accepted, evidence-based economic reality that has driven much of the recent and frenzied bailout activity by the Treasury, including the $85 billion loan/equity play to AIG, the shotgun sales of Bear Stearns, and Washington Mutual, and Federal Reserve's approval of the marriage of Wachovia with Wells Fargo, which will create the largest bank branch network in the United States. Moreover, the economic shock waves from the decision not to rescue Lehman Brothers, despite its size and financial reach, may well serve as the dramatic counterpoint for those who thought that "too big to fail" was a myth. Of course, much has happened since the earlier debate, including the inclusion of non-banking financial institutions under the "too big to fail" tent, and the evolution of a new universe of entanglements among those institutions and their world-wide counterparts occasioned by the creation of an exotic, complex and opaque layering of derivative instruments and guarantees that suddenly threatened to take down many financial entities that are not "too big to fail" at all. Clearly, neither the authors of this new paradigm, nor the various regulators who presided over its propagation throughout national and international markets, understood its far-reaching implications.

2.The last remnants of any legal distinction between investment banking and commercial banking effectively disappeared when, overnight, the Federal Reserve granted bank holding company status to Goldman Sachs and Morgan Stanley. While this decisive and far-reaching action is most likely validated by the capital benefits to both these financial giants emanating from having their bank holding company status, there should be a prompt and heightened level of regulatory scrutiny going forward that assures the preservation of critical, internal barriers at each of these institutions between their investment and commercial banking functions.

3. Because of the gravity of the financial crisis, the financial services industry has had to open its kimono to a lurid parade of regulator intrusions without seeming boundaries. Consider: the creation of federal equity interests (structured as warrants) in banks from whom the Treasury purchases troubled assets; the potential acquisition

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of control of AIG, the nation's largest insurance company, by the United States if its $85 million dollar loan from Treasury is not timely repaid; the increase by the Federal Reserve from 25% to 33% of ownership in a bank before the purchaser becomes a bank holding company; various, new federal spigots for controlling availability and flow of capital; the placement of both Fannie Mae and Freddie Mac in custodianship; and, limitations on executive compensation and severance benefits, to name a few. Federal regulators now have an omnipresence deep inside our banking system, or at least among those institutions requiring assistance, that we have never before witnessed. The question: will this unprecedented regulatory colonization ultimately spread under the banner of prophylaxis to relatively healthy institutions as well?

4. While federal intervention is crucial to restoring both confidence in the banking system and the availability of capital, the public finds nothing to like in the Act, and evinces little understanding of the macroeconomic principles that propelled its passage and ultimately threatened the economic well-being of the average American. The long- term credibility of most financial institutions outside of sound community and regional banks is at low ebb. The public mood is retributive and frightened, not restorative. In this hyper-charged climate, Congress gets rare kudos for decisively acting in the face of genuine political risk to protect the public from a self-destructive path.

5. The banking industry has apparently succeeded in using its political clout in the cause of securing passage of the Act to accomplish important concessions, or at least serious reconsideration, of the "mark to market" accounting rules, even though the role that those rules played in causing or even hastening the financial services crisis is murky. Certainly, the impact of "mark to market" on the volatility of the drying up of capital is worth the expected "instant replay" by the accounting and regulatory communities.

6. Amidst all of the convolutions of the market and the breathtaking array of regulator interventions, it is all too easy to forget that the bedrock problem underlying the economic crisis—the depressed value of residential real estate relative to the debt loads that burden it –has not gone away, and likely will not for some time to come. The revitalization of the capital markets which will hopefully follow implementation of the Act, as well as collateral actions by the Federal Reserve and the Treasury, will certainly aid in remedying the underlying problem; but, in the end, it will take a collective restoration of confidence on the part of the American people to restore economic normalcy.

7. While there is no empirical measure that we are aware of, it would seem in retrospect that, from a regulatory perspective, two phenomena emerged from the heady days, months and years that preceded the current melt down: first, the peeling off through a myriad of derivative instruments, of different components of risk had the effect of increasing the appetite for risk among those creating and/or purchasing those instruments; and second, the pervasive use of such instruments caused an increase in capital volatility; i.e., the same capital could be laid off at an accelerated pace to other suppliers of capital who could then make use of it, also at an accelerated pace. Clearly, these phenomena, if we are correct about their existence, did not raise sufficient regulatory red flags leading up to the present crisis. Going forward, the regulator community should pay heed to not only the true value of the assets which underlie the assessment of the risk inherent in any derivative instrument secured or guaranteed in some way by those assets, but also in the sequence of, and the frequency with which, those assets are "sliced and diced" to create additional capital flows. At the front end, this latter task will require a transparency and tracing of asset pools through chains of lenders and borrowers that was not in evidence as the current economic crisis unfolded.

8. It remains to be said, but in a regulatory context it is worth oft-repeating, that the conservative assessment of risk, the application of fundamental principles of sound underwriting, and the proper servicing and oversight of outstanding debt, buffer any prudent bank or other lender from the threat of ruin that a number of financial institutions have faced in recent days. While it is not possible in the current economy for any bank to be fully inoculated against the drying up of capital, certainly Delaware's community and regional banking institutions have proven their unswerving commitment to those fundamentals that have always buttressed the United States banking system. Our regulatory community would do well to make sure that emerging technologies and exotic financial products do not again either trigger the abandonment of these fundamentals across the financial services spectrum, or spawn a new economic bubble borne by the winds of greed that sweeps all of us in its path.

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