

## Financial Services and Products ADVISORY

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### \$700 Billion Mortgage Bail-Out Takes Shape

Over the past few days, the Treasury Department and Congress have been negotiating the terms of a mortgage bail-out program. During the weekend, the Treasury Department issued a legislative proposal outlining its concept of the program.<sup>1</sup> As of late yesterday, Treasury had produced an updated version,<sup>2</sup> and the chairmen of the banking committees in the Senate and the House had released their own discussion drafts of possible bills.<sup>3</sup>

Under all of the proposals, Treasury would be permitted to purchase \$700 billion in mortgage-related assets from U.S.-based financial institutions over a two-year period in order to improve current credit availability. However, there remain some significant differences. It should also be noted that, though each of the proposals is relatively straightforward, each — like much of the recent activity of the federal government to ameliorate the financial crisis — defers important policy decisions and may have consequences that are not fully anticipated. The pricing mechanism for both purchases and sales of assets and the eligibility standards (if any) for sellers and buyers remains very much up in the air. The program may well have indirect effects on housing prices and the near-term availability of housing credit, but no forecasts have been provided.

No bill has yet actually been introduced in either house of Congress, and no floor action on the matter was scheduled for today. Because Secretary Paulson and Chairman Bernanke testified before the Senate Banking Committee today and are scheduled to appear before the House Financial Services Committee tomorrow, formal legislative activity seems unlikely to occur until those hearings are completed.

### Structure of the Bail-Out Program

- **Basic Authority.** Under the latest version of the Treasury Proposal, Treasury would be authorized to issue up to \$700 billion of Treasury securities to purchase “Troubled Assets” over a two-year period. Assets purchased would be measured against the \$700 billion simply at the purchase price of the assets. Interestingly, the documents are not consistent on the application of the \$700 billion cap. Section 6 of the Treasury Proposal would limit Treasury to \$700 billion outstanding

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<sup>1</sup> Treasury released two documents on Saturday, September 20 — the text of proposed legislation and a fact sheet (the “Fact Sheet”) describing the Proposed Bill.

<sup>2</sup> Treasury has not posted the proposal on its website, but we will refer to it herein as the “Treasury Proposal.”

<sup>3</sup> Although there are no formal citations for either discussion draft, we will refer to them herein as the “Dodd Bill” and the “Frank Bill.”

in mortgage-related assets at any time, and implicitly would allow Treasury to sell assets and use the proceeds to purchase additional assets. The Fact Sheet, by contrast, suggests that the \$700 billion cap is Treasury's total purchasing authority; it could not use the proceeds from the sales of mortgage-related assets to purchase additional assets.

The Dodd and Frank Bills include similar authority, with the same \$700 billion "outstanding" cap. The Dodd Bill also would establish a formal Office of Financial Stability within Treasury's Office of Domestic Finance to manage the program.

- **Eligible Assets.** According to the Treasury Proposal, "Troubled Assets" include whole loans and mortgage-related securities<sup>4</sup> – but only if the asset was originated or issued on or before September 17, 2008. Although both the Treasury Proposal and the Fact Sheet invoke the concept of a "troubled" asset, the definition includes no element of under-performance. Treasury would have the legal authority to purchase any mortgage-related assets, even if fully performing. Additionally, Treasury may, in consultation with the Federal Reserve, expand the definition of Troubled Asset to include any other financial instrument, the purchase of which is determined "necessary to promote financial market stability."

The Dodd and Frank Bills contain essentially the same definition of Troubled Asset, including the omission of any indication that an asset is not performing. Notably, however, the Dodd Bill has an earlier cut-off date of March 14, 2008. The Frank Bill contains Treasury's September 17 date.

- **Legal Standards.** There are no fixed legal standards in the Treasury Proposal, other than the \$700 billion cap (itself an ambiguous limit), the two-year time limit on purchases and a directive (but not a requirement) to take appropriate steps to manage conflicts of interest in the hiring of contractors or advisers. The Treasury Proposal directs Treasury to "take into consideration" two factors: "providing stability or preventing disruption to the financial markets or banking system" and "protecting the taxpayer." There is no hard-and-fast standard, however, as there is, for example, in the duty of the Federal Deposit Insurance Corporation (FDIC) to resolve failed banks at "least cost."

Section 11(a) of the Frank Bill suggests a more measurable standard, although it may be diluted by the factors underlying the standard. The Frank Bill would require Treasury to use its authority "in a manner that will minimize any potential long-term negative impact on the taxpayer." The analysis of the impact, however, is a complicated one and possibly not susceptible to meaningful review. The analysis would include direct outlays, potential long-term returns on assets held by Treasury and the overall economic benefits of the program. The Dodd Bill is similar to the Treasury Proposal on this point.

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<sup>4</sup> The term is defined in the proposed legislation as "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages."

- **Reviewability of Treasury Decisions.** Section 8 of the Treasury Proposal would make Treasury's decisions entirely unreviewable by any court or administrative agency. The Dodd and Frank Bills would allow for judicial review on an arbitrary or capricious standard. According to press reports, Treasury is amenable to some form of judicial review.

### Troubled Asset Purchases

- **Eligible Sellers.** The authorizing language in section 1 of the Treasury Proposal would enable Treasury to purchase mortgage-related assets from any "financial institution" with "significant operations" in the United States. The term "financial institution" includes, but is not limited to, banks, thrifts, credit unions, broker-dealers and insurance companies. Other entities holding "Troubled Assets" presumably could qualify, including any U.S.-based trust holding a pool of securitized mortgage loans. The U.S. geographic restriction would be flexible. Section 10 of the Treasury Proposal would enable Treasury, in consultation with the Federal Reserve, to determine that "broader eligibility is necessary to effectively stabilize financial markets." The Dodd and Frank Bills take a similar approach.
- **Price of Purchases.** The Treasury Proposal gives Treasury broad authority to purchase mortgage-related assets and does not specify any pricing or settlement process. The Fact Sheet states that, in making purchases, Treasury will use market mechanisms "*where possible*" and specifically refers to reverse auctions as one such mechanism. The Dodd Bill similarly is silent on any pricing mechanism. The Frank Bill does not specify a mechanism, but it does contain a more elaborate description of the factors to be taken into account in purchasing and selling assets.
- **Equity Interests.** The Dodd Proposal would require any institution selling Troubled Assets to provide "conditional shares." The proposed terms of these shares are complicated, but may be best understood in economic terms as a kind of warrant to protect Treasury against losses on Troubled Assets. The conditional shares would vest with Treasury upon such a disposition of the Troubled Assets that results in a loss, and the number of shares would be determined in a way that takes account both of the loss and of price gains in the shares of the seller after the sale to Treasury of the Troubled Assets. Although neither the Frank Bill nor the Treasury Proposal contains a similar provision, Chairman Frank, Secretary Paulson and Chairman Bernanke are, according to press reports, receptive to some kind of equity feature.

### Asset Management

- **Management Responsibilities.** Under section 5 of the Treasury Proposal, Treasury would be able to exercise all rights received in a purchase of Troubled Assets and would have broad discretion to manage the assets. Treasury may manage the assets itself or designate third parties to do so, and has broad discretion in making these decisions. The Dodd and Frank Bills similarly would grant fairly broad discretion, but the two bills would specifically require greater attention to foreclosure prevention and loan modification.

- **Role of the FDIC.** The Treasury Proposal does not suggest any role for the FDIC. Section 5 of the Dodd Bill would assign responsibility for the management of residential mortgage loans and mortgage-backed securities to the FDIC. In managing these assets, the FDIC would be required to utilize an unspecified “systematic approach” for preventing foreclosures and ensuring affordable home ownership through loan modifications. The FDIC already has begun to defer or stop foreclosures and to increase loan modifications with respect to depository institutions now under its control. The Frank Bill does not provide a role for the FDIC, but it includes instructions similar to the Dodd Bill on protecting the interests of borrowers.
- **Use of Third Parties.** Under the Treasury Proposal, Treasury would be able to contract, without regard to customary government contract restrictions, with third parties to provide any services needed. Specifically, Treasury would have the authority to designate financial institutions as financial agents to perform any duties required by Treasury. The Dodd and Frank Bills are consistent on this point.

### Troubled Asset Sales or Other Dispositions

- **General Authority.** Section 5(c) of the Treasury Proposal would authorize Treasury to sell any mortgage-related assets at such prices and under such terms and conditions as Treasury may determine. Treasury is not limited to direct sales, however. It may enter into securities loans, repurchase transactions or other financial transactions. Indeed, section 2(b)(4) would allow Treasury to securitize the assets that it purchases or engage in other transactions through special purpose vehicles. Secretary Paulson has indicated that Treasury is likely to use this disposition authority.

The Dodd and Frank bills contain comparable provisions. With respect to residential mortgage assets that the FDIC would manage under the Dodd Bill, the FDIC would be the seller, but terms and conditions and prices would be set by Treasury.

- **Eligible Purchasers.** The Treasury Proposal places no limits on eligibility to purchase mortgage-related assets from Treasury. Other government-sponsored resolution programs, including the RTC, have prevented some market participants involved in troubled organizations, or in the creation of assets that became troubled, from investing in or buying back those institutions or assets; it remains to be seen whether Treasury would impose any limits. The Dodd and Frank Bills also do not specify any eligibility criteria.
- **Use of Proceeds.** The Treasury would, under the Treasury Proposal, retain all sale proceeds and place resulting profits (after payment of expenses) in Treasury’s general fund. The Dodd Bill would require that at least 20 percent of any profits be contributed to the Housing Trust Fund and the Capital Magnet Fund.

## Administrative Issues

- **Public Debt Issues.** The Treasury securities issued to fund the purchases would be considered part of the public debt, and section 10 of the Treasury Proposal raises the public debt ceiling accordingly.
- **Oversight.** The Treasury Proposal has no oversight mechanism (apart from, implicitly, oversight by the President). The Dodd Bill would establish an Emergency Oversight Board with five members, including the heads of the Federal Reserve, the SEC and the FDIC, and two members appointed by Congress. The Frank Bill would create a seven-member Congressional Oversight Panel, with all members appointed by Congressional leaders. Either oversight body would review Treasury's actions and their effects, and the Dodd board could make recommendations to the Treasury Secretary. Neither body could overturn Treasury decisions. Press reports reflect that Treasury is agreeable to some form of oversight.
- **Reports.** The Treasury Proposal would require a report to Congress within three months after the first purchase of mortgage-related assets and semi-annual reports thereafter. The Dodd and Frank Bills would require more frequent reports.

## Provisions Solely in the Dodd and Frank Bills

- **Bankruptcy Relief.** Reviving a proposal much favored by Democrats, the Dodd and Frank bills both would authorize federal bankruptcy judges to modify residential mortgage loans in certain circumstances. The Bush Administration is opposed, and the outcome of this particular issue is unclear.
- **Limits on Executive Compensation.** The Dodd and Frank Bills would limit executive compensation arrangements for those institutions selling Troubled Assets. Developing the limits would be the responsibility of Treasury and would have to include restrictions on incentives that would encourage excessive risk-taking, claw-backs based on criteria later found to be inaccurate and restrictions on severance payments.

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