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US Financial Stability Plan likely to benefit investors active in ABS, distressed debt

Despite its much-criticized lack of specifics, the US Treasury's Financial Stability Plan points to significant benefits to institutional investors active in asset-backed securities and to those experienced in dealing with distressed debt. The plan also confirms that the Obama Administration remains committed to private sector management of the financial sector, to the use of joint public-private financing to revive the credit markets, and to private sector pricing of "legacy" toxic and illiquid assets and newly issued financial instruments supported by government funding.

The US Financial Stability Plan (FSP) announced by Treasury Secretary Geithner on February 10, 2009, provides investors in newly issued asset-backed securities (ABS) and "legacy" toxic and illiquid assets with additional government funding and seeks to restore market confidence in major financial institutions by subjecting them to standardized "stress testing" and making available to those institutions additional government investment to provide a "capital buffer." It also directs additional credit to small businesses and residential mortgage holders facing foreclosure. Revival of the securitization markets and creating a market in "legacy" toxic and illiquid assets is a major theme of the FSP, providing public funding to support investors in those markets and enabling institutional investors, rather than the government, to effectively price and manage the financial assets purchased.

The FSP will increase fivefold (by $800 million) the amount of federal funds available to support the issuance of certain ABS with limited recourse funding jointly backed by the Treasury and the Federal Reserve Board under an expanded Term Asset-Backed Securities Loan Facility (TALF). It also will create a Public-Private Investment Fund (PPIF) to purchase "legacy" toxic or illiquid assets.

Initial reaction to the FSP among market participants has been generally negative, due mostly to a lack of specific details in the various programs. The announcement did not specify how the PPIF would value the assets it will purchase, nor did it specify how government funding would be used to leverage private capital. Similarly, the announcement did not explain what assumptions would be used in the "stress testing" and in the establishment of "capital buffers" for regulated banking institutions to deal with likely markdowns on the "legacy" toxic and illiquid assets on their balance sheets. Even one of the most concrete FSP announcements – the expansion of TALF – promises additional funding for a program which has not yet begun to operate.[1]

While these issues and other questions regarding the implementation of the FSP will be addressed over the coming weeks, the announcement does provide fundamental insight into the approach of the Obama Administration to the financial markets crisis.

First and foremost, the FSP reflects a continuing approach by U.S. financial policy makers which believes that government is ill-suited to running financial institutions. There is no hint of nationalization, irrespective of the level of financial support to regulated financial institutions (subject, of course, to long-standing arrangements for the "resolution" of failed banks by the FDIC).

Second, this continuing commitment to private sector management of financial institutions is also reflected in the approach to pricing asset purchases – whether purchases of consumer and small business ABS under TALF or purchases of "legacy" assets by the newly-announced PPIF: prices are to be set by private sector investors and institutions rather than by government.

Third, the FSP again demonstrates a preference for unfreezing specific credit markets, if possible, by providing government or government-backed funding to investors. This was the approach used by the Federal Reserve with its AMLF funding to investors to help revive the asset-backed commercial paper markets; it is also the approach of TALF, in which joint Treasury-Federal Reserve Board limited recourse funding of investors in certain types of highly-rated ABS is expected to resuscitate the markets for those securities.

Fourth, the FSP focuses on disclosures about regulated banking institutions and the extent of the "legacy" assets which they hold, with the purpose of permitting better informed decision-making about counterparty risk in the financial markets and of encouraging private sector investment in such institutions. FSP attempts to accomplish this by a uniform "stress testing" exercise of the largest banking groups and the establishment of a "capital buffer" through Treasury investment in convertible preferred shares (the "Capital Assistance Program" or "CAP") to cover additional losses which may arise at such institutions, and by the periodic disclosure of additional information about the condition and operations of all government-assisted institutions.

1 The Treasury Department and the Federal Reserve Board have stated that the first purchases of ABS under TALF are to take place during February 2009.

Thus, the FSP claims that it will not insert government directly into the business decisions of struggling financial institutions and other market participants. Instead, the plan has been crafted with the role of the government limited to the provision of debt and equity capital, to prudential supervision of the institutions receiving such assistance, and to enhanced disclosure to facilitate informed markets, management accountability and to encourage private investment in such institutions. That being said, FSP is not devoid of intrusion into such institutions' decision-making, as evidenced by government-mandated restrictions on executive compensation, on the use of government funds by such institutions, on share repurchases and acquisition transactions, and on required participation in residential mortgage modification programs. Government intervention in financial institution decision-making is a more insistent theme in the Congress than at the Treasury Department or the Federal Reserve. Greater restrictions on executives' bonus payments were inserted by Senator Dodd (Chairman of the Senate Committee on Banking, Housing and Urban Affairs) in the financial stimulus legislation enacted last week. While Congressional criticism of Wall Street can be expected to continue, rhetoric could turn into increasingly intrusive governmental intervention each time the Obama Administration has to return to Congress for additional crisis-related appropriations.

The greatest criticism of the FSP has been its lack of specificity. While this might be forgiven in a newly minted Treasury Secretary, it was unexpected coming from a man who has been in the inner circle of decision-makers since the crisis began, in his role as President of the Federal Reserve Bank of New York. Most disappointing was the failure to provide much guidance as to how PPIF will operate – the key element of the FSP aimed at the to-date intractable problem of "legacy" toxic and illiquid assets on financial institution balance sheets. Geithner's predecessor, Hank Paulson, was unable to address the problem, despite the fact that these "troubled assets" were the targeted focus of the TARP legislation enacted in October 2008 in the immediate aftermath of the Lehman bankruptcy.[2]

PPIF as the chosen instrument to address legacy assets may be similar to TALF in providing funding to investors. TALF involves non-recourse loans to U.S. investors (including the subsidiaries of foreign firms and investment funds organized and managed in the United States), permitting them to acquire or carry a large portion of the cost of eligible assets which, in the case of TALF, are high quality, newly issued ABS. Investors determine the purchase price they will pay for such ABS, and the risk of such ABS defaulting is shared between the investor and government, since the amount of the non-recourse government loan to the investor (through a special purpose vehicle) involves a "haircut" to the face value of the ABS.[3] The challenge to PPIF is that, unlike

2 See Baker & McKenzie's CLIENT ALERT: Senate Passes Amended Version of Emergency Economic Stabilization Act of 2008; SEC Clarifies FASB 157; Treasury Acts on Money Market Guarantees (October 2008) and CLIENT ALERT: If Enacted, Proposed Emergency Economic Stabilization Act of 2008 Leaves Many Questions Unanswered regarding Participating Financial Institutions (September 2008).

3 In the case of TALF, newly announced standards for the first round of TALF loans involve haircuts of between 5% and 16% for various categories of TALF-eligible collateral, depending upon the type of ABS assets involved and the expected life of the ABS. All TALF-eligible collateral must be AAA-rated.

TALF, PPIF involves low quality assets and substantially greater credit risk. TALF is principally funded by the Federal Reserve (which, as always, has a low tolerance for credit risk), with first loss coverage by Treasury from TARP money. If PPIF is in any way similar in form, Treasury will need to bear a much higher proportion of potential losses. Some non-funded coverage of such losses may also be possible through FDIC guarantees or the TARP insurance program originally contemplated in the Emergency Economic Stabilization Act. In any event, PPIF is focused on "large scale asset purchases," in contrast to TALF, which is expected to be widely used by a broad range of investors.

The FSP's significance will probably be greatest for institutional investors which have been active in the ABS markets. They should benefit from the five-fold expansion of TALF, its expansion to commercial mortgage-backed securities (CMBS), and the indication that it may be further expanded to cover non-Agency residential securities (RMBS) and assets collateralized by corporate debt. It will also benefit institutional investors experienced in working with distressed assets, who will benefit from PPIF once its operational modalities are announced. More broadly, financial markets should benefit from greater certainty about the creditworthiness of regulated banking institutions as a direct result of the "stress testing" and CAP elements of the FSP. FSP represents a strong commitment by the United States government to revive the American financial markets, drawing on its experience to date of some success in reviving the commercial paper and other short-term financial markets.[4]

4 The Federal Reserve created separate facilities to (i) provide a liquidity backstop to U.S. issuers of commercial paper, (ii) provide loans for the purchase of asset-backed commercial paper from money market mutual funds and (iii) directly purchase certificates of deposit, bank notes and commercial paper. These three programs together supported over 20% of the U.S. commercial paper market from November 2008, and have recently fallen to approximately 17% of market as of January 28, 2009. See http://www.financialweek.com/apps/pbcs.dll/article?AID=/20090213/REG/902139982/1036. Although the programs were scheduled to expire in April of this year, each has been extended to October 30, 2009.

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