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EESA Update: TARP-CPP Application Process and Interagency Coordination Round Two

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Over the past several days, the Treasury Department, Federal Deposit Insurance Corporation ("FDIC"), and Federal Reserve Board ("FRB") have issued another round of pronouncements on the Troubled Asset Relief Program ("TARP") established by the Emergency Economic Stabilization Act of 2008 ("EESA") and related economic stabilization programs.

First, the Treasury issued guidance on the application process for participation in the TARP Capital Purchase Program ("TARP-CPP"). This process will be used to allocate the second half of the $250 billion of funding that the Treasury set aside for this program. The first $125 billion was allocated for equity investments in nine of the largest U.S. banks. Notwithstanding the executive compensation restrictions and heightened regulatory scrutiny that will accompany these equity investments by the U.S. government, for many institutions the favorable financial terms override the additional operating limitations.

Second, the FDIC has indicated that proposed rules on its Temporary Liquidity Guarantee Program ("TLGP") will be out soon. In the meantime, the agency has provided additional insights into the program in a series of industry conference calls.

Finally, the FRB continues to build out its arsenal of liquidity programs with the introduction of another liquidity facility, the Money Market Investor Funding Facility ("MMIFF"). The program, complementing its Commercial Paper Funding Facility announced last week, is designed to stabilize funding issues for money market mutual funds.

The TARP-CPP Application Process

A primary objective of the EESA was to utilize the $700 billion in allocated funding to enable financial institutions to begin providing credit again, while minimizing the burden on taxpayers and maximizing the economic recovery impact. A key tool that the Treasury Department is implementing to achieve this objective is capital infusions into depository institutions through the TARP-CPP.

Pursuant to the TARP-CPP, the Treasury will purchase up to $250 billion of senior preferred shares on standardized terms from banks, savings associations, and depository holding companies engaged only in financial activities, that elect to participate in the program by 5 pm (EST) on November 14, 2008. The Treasury will determine eligibility and allocations for these Qualified Financial Institutions ("QFIs") after consultation with each QFIs' appropriate federal banking regulator. Treasury issued guidance on the

TARP-CPP on October 20 (see below), including instructions that institutions interested in participating in the program should contact their primary federal regulator for specific enrollment details.

In its October 20, 2008 guidance, the Treasury provided a single application form that QFIs may use to submit to their primary banking regulator. The guidance stressed that all QFIs applying before the November 14 deadline will receive the same terms, i.e., the program is not being implemented on a first-come first-served basis. The guidance also noted that the Treasury is coordinating with the banking agencies to maintain streamlined evaluations and a standardized process to ensure consistency. After the primary banking regulator reviews a QFIs' application, the agency will forward the application along with a recommendation to the Office of Financial Stability ("OFS") at the Treasury. The OFS will review the application and recommendation and make a determination whether to make the capital purchase. All transactions will be publicly announced within 48 hours of execution. Applications that are withdrawn or denied will not be announced.

Regarding confidentiality of information provided in an application, any QFIs desiring confidential treatment of all or a part of an application must submit with the application a request in writing identifying the specific information for which confidentiality is requested. Although a rejected application will not be published, an approved application will be publicly available, except for sections the QFIs specifically requested and the regulatory agency granted confidential treatment.

Stressing the importance of the TARP-CPP in increasing the capital base of QFIs to provide lending necessary to support the U.S. economy, the Treasury indicated that it intends to fund senior preferred shares purchased under the program by year-end 2008. All QFIs selected to receive an investment under the TARP-CPP must agree to all terms and conditions of the program, and agree to make the various representations and warranties required by the investment agreement and related documentation for the program. A term sheet for the program is currently available on the Treasury website (see below) and the investment agreement and related documents will be posted to the website when available. the Treasury indicated that after an institution receives preliminary approval to participate in the TARP-CPP, it will have 30 days to provide the executed investment agreement and documentation.

The guidance provides that all capital purchases will be made at the highest-tier holding company for institutions in a holding company structure and will involve the purchase of non-cumulative perpetual preferred stock in institutions not in a holding company structure. It also notes that, during the first three years of a TARP-CPP investment, an institution may not increase its dividend payments on common shares – nor may it repurchase or redeem common shares and most preferred shares – without the permission of the Treasury.

The guidance further reiterates, as noted in previous statements about the program, that the senior preferred shares will qualify as Tier 1 capital; rank senior to common stock and, generally, equal with existing preferred shares; pay a cumulative annual dividend of 5 percent the first five years and 9 percent thereafter; generally, be non-voting; be callable at par after three years, but prior to that may be redeemed with the proceeds from a qualifying equity offering of any Tier 1 perpetual preferred or common stock.

In addition, the guidance reminds prospective applicants about the executive compensation restrictions imposed by the EESA and the Treasury under the TARP. Finally, the guidance highlighted the agency's authority to transfer the senior preferred shares to a third party at any time; and, in conjunction with the purchase of senior preferred shares, the Treasury's receipt of warrants to purchase common stock with an aggregate market price equal to 15 percent of the amount of the TARP-CPP investment.

Analysis of the TARP-CPP Process

While the Treasury is encouraging QFIs to apply for participation in the TARP-CPP, it is not clear whether this is the most advantageous move for every QFI. While the financial terms are advantageous, the program limits participating institutions in a variety of ways. These include restrictions on employment compensation, acquiescing to certain required terms and conditions, and any additional operating restrictions imposed under the program. At this point, investment agreement terms and conditions, required representations and warranties, and the program selection criteria remain unclear. In addition, QFI interest is likely to far outstrip available funding for the program. Many QFIs will likely not be part of the program, whether by choice or the selection process. With these factors in mind, each QFI should evaluate whether applying to participate in the TARP-CPP is right for them.

FDIC Insights on the TLGP

As discussed in our October 15, 2008 EESA update, the purpose of the TLGP is to encourage liquidity in the banking system by guaranteeing newly issued senior unsecured debt (until June 30, 2009) of participating banks, thrifts, and holding companies, and by providing full deposit insurance coverage for non-interest bearing deposit transaction accounts until December 31, 2009. To date, the FDIC has released a two-page Financial Institution Letter (FIL-103-2008) and a three-page TLGP FAQs document (see below), but many unanswered questions remain. In an effort to address some of these issues, the FDIC has hosted several conference calls that have produced a number of questions about the coverage and applicability of both prongs of the TLGP. While the calls have produced some preliminary answers and observations by agency staff, more concrete guidance is expected with the issuance of an FDIC interim rule implementing the TLGP scheduled for Thursday, October 23, 2008. Reportedly, the rule will have a 15-day comment period from the date it is published in the Federal Register. Publication is expected on or near October 29.

Based on the information currently available on the TLGP, a number of observations are worth noting:

- While the Treasury's announcement regarding the TARP-CPP application process states that the TARP-CPP and TLGP should be viewed as complementary, the extent of coordination between the agencies on these programs is unclear. All that is known currently is that the Treasury is implementing the TARP-CPP and the FDIC is implementing the TLGP. It is unclear whether both programs will be available to the same institutions and there appears to be a disparity between entities that may participate in the TARP-CPP and those eligible for the TLGP.

- Until the FDIC issues its proposed rule on the TLGP, program overlap remains uncertain (and may continue). Certainly, there may be interesting timing issues for QFIs that must apply for the TARP-CPP by November 14 if there is not clarity on the issue of program overlap and/or TLGP eligibility. For example, a QFI may find it more appealing to issue debt to the Treasury under the TARP-CPP than to wait to issue guaranteed debt to third parties under the TLGP if there is uncertainty about the ability of that debt to qualify for the TLGP.

- While institutions may seek to participate in both the TARP-CPP and TLGP, uncertainty about Treasury's selection process and the FDIC's TLGP selection criteria currently makes planning for such simultaneous deal-making difficult.

- Banks, thrifts, and certain holding companies are automatically covered by the TLGP until November 12, 2008, and must opt out of the program (through a form that will be provided on the FDIC website or FDIC connect) by that date if they do not want to retain its coverage. Institutions may opt out of either or both parts of the program (debt guarantee or expanded deposit insurance coverage), but they cannot opt out after November 12 nor can they later choose to opt back in. In addition, a bank or thrift may elect to remain in the program even though its parent holding company elects to opt out.

- Guarantee coverage for newly issued debt under the TLGP will be available only until June 30, 2012. The FDIC indicated that it would pay both principal and interest through the date of failure of an eligible institution. Any holder of guaranteed debt would work through a claims process in the event of a failure, and that process would be different for debt issued at the holding company level (where a bankruptcy court would control the holding company's assets).

- With respect to the increase in deposit insurance coverage for non-interest bearing transaction accounts, there are a number of account structures presenting interpretive difficulties for the FDIC and institutions, and a number of depositors do not understand how certain accounts (sweeps, repos, etc.) are structured.

- While the amount of debt covered by the TLGP may not exceed 125 percent of debt outstanding as of September 30, 2008 (that was scheduled to mature before June 30, 2009), unclear is the amount of such debt that will be guaranteed for entities with little or no debt on September 30, 2008. The FDIC has indicated that it will determine this on a case-by-case basis in consultation with the eligible firms primary federal regulator.

- The FDIC will impose restrictions on the use of the proceeds from any debt issuances under the TLGP, including prohibiting the issuance of new debt to extinguish pre-existing debt that carries a higher interest rate.

We anticipate significantly greater clarity on the timing, terms, conditions, and requirements for eligibility in the TLGP with the issuance of the FDIC's proposed rule next week.

The FRB's Latest Liquidity Tool: The MMIFF

Yesterday, the FRB announced its latest liquidity tool, the MMIFF. The new facility is designed to stabilize funding for money market mutual funds and complements the FRB's Commercial Paper Funding Facility ("CPFF"), announced several weeks ago to stabilize funding in the commercial paper market, and its Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF"), announced in September to provide funding to banks to purchase asset-backed commercial paper from money market mutual funds.

The MMIFF is intended to provide additional liquidity to money market mutual funds by financing assets (including CDs and short-term commercial paper) from eligible funds. For now, the program is available only to U.S. money market mutual funds, but the FRB indicated that it may eventually be available to other U.S. money market investors.

As noted in the FRB's press release announcing the new facility (see below), the AMLF, CPFF, and MMIFF collectively are intended to improve liquidity in the short-term debt markets and thereby increase the availability of credit. Credit availability remains the consistent theme of all of the government's efforts to date. Interestingly, this contrasts sharply with the regulatory undercurrent coming out of the last U.S. financial crisis in the late 1980s and early 1990s that ultimately led to Congressional concerns about a "credit crunch" created by the banking regulators' response to that crisis.

Following are the links to the information discussed above:

Joint Interagency Release on the TARP-CPP and TLGP:

http://www.fdic.gov/news/news/press/2008/pr08103.html

Original Description of the TARP-CPP:

http://www.treas.gov/press/releases/hp1207.htm

TARP-CPP Application Guidelines:

http://www.treas.gov/press/releases/reports/applicationguidelines.pdf

TARP-CPP Summary Term Sheet:

http://www.treas.gov/press/releases/reports/document5hp1207.pdf

TARP-CPP FAQs:

http://www.treas.gov/press/releases/reports/faqcpp.pdf

FDIC Announcement Regarding Creation of the TLGP:

http://www.fdic.gov/news/news/press/2008/pr08100.html

FDIC Additional Guidance on the TLGP (FIL-103-2008):

http://www.fdic.gov/news/news/financial/2008/fil08103.html

FDIC TLGP FAQs:

http://www.fdic.gov/regulations/resources/TLGP/faq.html

FRB Announcement on Creation of the MMIFF:

http://www.federalreserve.gov/newsevents/press/monetary/20081021a.htm

MMIFF Terms and Conditions:

http://www.federalreserve.gov/newsevents/press/monetary/monetary20081021a1.pdf

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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