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# US CORNER

## The Troubled Asset Relief Program: An Overview

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### Introduction

Intended to invigorate frozen credit markets, the Troubled Asset Relief Program ('TARP') enacted under the Emergency Economic Stabilization Act in October 2008 has been controversial from its inception. With the last of the initially authorised USD 350 billion now earmarked for the struggling auto makers, the TARP administrators at the Department of the Treasury have been criticised for failing to adequately address home foreclosures and to monitor the recipients' use of TARP funds. Initially conceived as a potent instrument authorising up to USD 700 billion for the purchase of troubled mortgage-related assets held by financial institutions, the TARP has been reconfigured as a government investment vehicle, injecting capital into a variety of entities (both struggling and otherwise) as the credit crisis progressed. The below summary outlines the principal provisions of TARP as well as the other Treasury programs utilising TARP funds to date.

### Principal TARP provisions

The Emergency Economic Stabilization Act of 2008 ('EESA') containing the TARP provisions was enacted on 3 October 2008, after much legislative brinksmanship. The original three-page bill forwarded to Congress by US Secretary of the Treasury Henry M. Paulson, Jr in mid-September had grown to 450 pages and was larded with extensions of certain tax benefits, energy tax credits and initiatives and sundry other items (including tax relief for wooden arrow manufacturers) unrelated to the financial bailout terms. The key TARP provisions are:

#### *Troubled asset acquisition*

– The US Secretary of the Treasury (the 'Secretary') is authorised under TARP to purchase 'troubled assets' from any 'financial institution'. 'Troubled assets' include residential or commercial mortgages and any securities, obligations or other instruments that are based on or related to such mortgages (originated or issued on or before 14 March 2008) and 'any other financial instrument' as determined by the Secretary, upon consultation with the Federal Reserve, to help financial market stability.
  - 'Financial institution' is broadly defined as any institution, including *but not limited to* banks, savings associations, credit unions, securities brokers and dealers, or insurance companies established and regulated under the laws of the United States and having significant operations in the United States. 'Financial institution' includes US branches of foreign banks but specifically excludes any central bank of, or institution owned by, a foreign government.

– *Market Mechanisms:* In making purchases, the Secretary will use market mechanisms as appropriate, such as auctions or reverse auctions.

– *Purchase Price:* The Secretary will purchase assets at the 'lowest' price deemed to be consistent with the purposes of EESA. In order to prevent unjust enrichment, the Secretary cannot pay more for a troubled asset than the amount paid by the seller (except for certain assets acquired through mergers or acquisitions).

– *Pricing and Management of Assets*: The Secretary will establish guidelines which include pricing and valuation methods, as well as selection procedures for the assets and the asset managers.

– *Equity Sharing:* The Secretary will receive warrants for nonvoting common or preferred stock or senior debt instruments in a selling financial institution, in each case where purchases are greater than USD 100,000,000. The Secretary is authorised to sell, exercise or surrender such warrants, equity or debt instruments in its discretion.

#### *Executive compensation limits*

– If troubled assets are acquired by the Secretary from a financial institution through direct purchases when a bidding process or market prices are not available, and the Secretary receives a 'meaningful equity position' in such financial institution as a result of the acquisition, then the financial institution must meet 'appropriate standards for executive

compensation and corporate governance'. For example, 'golden parachutes' are prohibited and 'claw back' provisions must be in place with respect to previously paid bonus amounts based on inaccurate earnings.

- If the troubled assets are purchased through auctions and such purchases from any individual financial institution exceed USD 300 million, the Secretary will prohibit any golden parachute for any senior executive officer hired *after* such auction. Previously agreed to severance packages would not be affected.
- Executive compensation for three highest paid employees in excess of USD 500,000 would not be deductible; 20% excise tax imposed on golden parachute payments for reasons other than retirement.

### Funds to be available in instalments

- The Secretary may initially have USD 250 billion of purchased assets outstanding at any one time. The President was permitted to submit (and did submit) a written certification to Congress and such authority was increased to USD 350 billion outstanding at any given time.
- An additional USD 350 billion is available to Treasury (bringing the total authorised amount to USD 700 billion) unless, within 15 days of the request, Congress objects through a joint resolution (which resolution is subject to a presidential veto). Administrative expenses are not included in the authorised amount.
- It has been reported that the formal request for the release of the remaining USD 350 billion TARP funds will be made by the Bush administration at the request of the incoming Obama administration. It is likely that motions formally disapproving such release will be introduced in each house of Congress.

### Insurance of troubled assets

- Upon request of a financial institution, the Secretary may guarantee the timely payment of principal and interest on troubled assets originated or issued prior to 14 March 2008, including mortgage-backed securities.
- In return, risk-based premiums will be collected from any financial institution participating in this insurance program, in the amount the Secretary determines necessary. The Secretary is required to publish the methodology for setting the risk-based premiums by asset class.
- Under the insurance program, financial institutions would keep troubled assets on their balance sheets and would more easily be able to fund the assets, through repo or other borrowings, without taking a loss.
- The Secretary is only required to establish the insurance program in the event TARP monies are used to purchase troubled assets. Accordingly, no such program has yet been established.

### Significant market transparency

- Within two business days of a Treasury asset purchase, the descriptions, amounts and pricing mechanisms of acquired assets will be made electronically available to the public.

### Termination of authority

- The Secretary's authority to purchase or insure assets expires on 31 December 2009. Troubled assets may be held beyond the termination date. The authority can be extended upon submission of written certification to Congress, but the extension can only be to a date not to exceed two years from the date of enactment (i.e., October 2010).

### Sale of assets

- Treasury may sell or enter into securities loans, repurchase transactions, or other financial transactions in regard to any troubled asset purchased by Treasury under the Act. The timing, pricing and terms and conditions of such sale are determined by Treasury. There is no stated limit on the length of time that Treasury may hold the assets.

### Oversight/reporting/audits

- *Reports to Congress*: Treasury is required to make regular monthly reports to Congress as well as additional detailed reports for every USD 50 billion of assets funded. Treasury issued its Fourth Tranche Report on 8 January, as its funding commitments under the Capital Purchase Program and Systemically Significant Failing Institution Program (each described below) had exceeded USD 200 billion.
- *Financial Stability Oversight Board:* A Financial Stability Oversight Board has been established to review the exercise of the Secretary's authority and make recommendations to the Secretary regarding use of the authority.
- *GAO Oversight:* The US Government Accountability Office has commenced ongoing oversight of


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activities and performance of TARP. In a December report, the GAO noted a need for Treasury to improve its transparency, accountability and integrity with respect to TARP.

- *Special Inspector General:* An Office of the Special Inspector General for TARP has been established with former Assistant US Attorney Neil Barofsky appointed by the President as the first Special Inspector General for TARP.
- *Judicial Review:* Actions taken by the Secretary will be set aside if found to be arbitrary, capricious, an abuse of discretion, or not in accordance with applicable laws.

### *Studies and reports*

Reports and recommendations on modernising the financial regulatory framework and related topics will be required by the Secretary, the Comptroller General, the Congressional Oversight Panel and the Office of Management and Budget.

## Other significant EESA provisions

### *Suspension of mark-to-market accounting*

- The statute restates the Security and Exchange Commission's authority to suspend the application of mark-to-market accounting standards contained in Statement of Financial Accounting Standards No. 157 as necessary to protect investors. As required under EESA, the SEC conducted a study on mark-to-market accounting standards, and, in a 30 December 2008 report to Congress, recommended that such standards *not* be suspended. Instead, the SEC recommended that the application of mark-to-market accounting standards be improved in a number of ways, including developing additional guidance for valuation in illiquid markets, enhancing financial statement disclosure and reassessing current impairment accounting models.

### *Assistance to homeowners/minimising foreclosures*

- The Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures. Each federal property manager must, within 60 days, implement a plan that seeks to maximise assistance for homeowners and will encourage servicers of underlying mortgages to take advantage of certain federal programs to minimise foreclosures.
- EESA allows for modifications to mortgage loans and encouragement by federal property managers to servicers to make these modifications, which include reduction of loan principal and/or interest rate.
- If the Treasury holds interests in pools of obligations secured by residential mortgage loans, then the federal property manager will encourage implementation by the loan servicers of loan modifications and assist in facilitation of such modifications.

### *Coordination with foreign authorities*

- The Secretary will coordinate with foreign financial authorities and central banks to establish similar programs to TARP.
- If foreign financial authorities or banks hold troubled assets as a result of implementing such programs, then such troubled assets will qualify for purchase by the Secretary under the US program.

### *Recoupment*

- After five years, if there is a projected loss within TARP, the President will submit a legislative proposal to recoup such loss from the 'financial industry', rather than simply participating institutions.
- This recoupment could include a proposal that fees or taxes be imposed on securities transactions; however, the EESA only authorises the President to submit a proposal, and there are of course no assurances of legislative passage.

## The Capital Purchase Program

By mid-November, Treasury had formally changed its stated focus from purchasing illiquid mortgage-related assets to direct capital investments in viable financial institutions. Faced with a continuing depressed market environment and the challenges in designing an auction scheme that would recapitalise the banking sector and stimulate lending, Treasury determined that injections of up to USD 250 billion of TARP funds would more quickly prop up capital depleted institutions. Under the Capital Purchase Program ('CPP'), Treasury initially invested USD 125 billion in nine large financial institutions in exchange for senior preferred shares, with the remaining USD 125 billion to be invested in smaller institutions. The principal CPP terms are as follows:

- Financially healthy US banks, savings associations and top-tier holding companies (as recommended by the banking regulators) may participate in the program, with a maximum subscription amount equal to 3% of an institution's risk-weighted assets, up to a USD 25 billion maximum;


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- Treasury receives non-voting senior preferred shares paying dividends of 5% for five years and 9% thereafter; preferred shares may be redeemed at face value after three years;
- Under the CPP Treasury also receives warrants to purchase common stock equal to a market value of up to 15% of the senior preferred securities, at an exercise price equal to the common stock price on the day the participating institution is accepted into the CPP.

Over 210 institutions have thus far participated in the CPP and agreed in the process to executive compensation limits and corporate governance reforms. Bank holding companies, banks and savings and loan holding companies controlled by a foreign bank or company are *not* eligible to participate in the CPP.

## Systemically Significant Failing Institutions Program – AIG

Treasury has also used TARP funds under its Systemically Significant Failing Institutions Program ('SSFI'), announced on 25 November. Under the SSFI, Treasury will identify institutions on a case-by-case basis whose disorderly failure would likely destabilise the credit markets or payment and settlement systems. Treasury has wide latitude under SSFI to determine the appropriate form of investment in the failing institution, which could take the form of equity, debt or warrants. In the case of American International Group (AIG), the only institution thus far to receive SSFI funds, Treasury acquired USD 40 billion in 10% senior preferred stock in AIG, which accompanied a restructuring of existing Federal Reserve-provided credit facilities and the provision of two additional lending facilities to AIG. As a condition for receiving the SSFI funds, AIG is subject to the executive compensation limits under EESA as well as additional corporate governance requirements.

## The Term Asset-Backed Securities Loan Facility

Treasury also intends to increase credit availability by leveraging TARP funds to spur the consumer-related securitisation sector. Under the new Term Asset-Backed Securities Loan Facility ('TALF'), the Federal Reserve Bank of New York ('FRBNY') will make available USD 200 billion for non-recourse financing to holders of newly issued AAA-rated ABS. The FRBNY will lend an amount equal to the market value of the ABS less a haircut for a three-year term and will be fully secured at all times by the ABS. TALF is expected to become operational in early 2009, and the facility will terminate on 31 December 2009, unless extended by the FRBNY. Treasury will provide USD 20 billion of credit protection to the FRBNY in connection with the facility, using funds from the EESA. The eligible collateral under the TALF will include:

- US dollar-denominated cash (but not synthetic) ABS issued on or after 1 January 2009 with long-term credit ratings in the highest category from at least two national rating agencies, and no lower rating;
- Eligible underlying credit exposures: auto loans, student loans, credit card loans, or small business loans guaranteed by the Small Business Administration, which may be expanded in the future to include commercial mortgages, residential mortgages and other asset classes;
- Underlying auto loan credit exposures must be originated on or after 1 October 2007; underlying SBA-guaranteed loan credit exposures must be originated on or after 1 January 2008; underlying student loan credit exposures must have a first disbursement date on or after 1 May 2007; and credit card ABS must be issued to refinance existing credit card ABS maturing in 2009, in each case to all or substantially all US-domiciled obligors;
- Originators of the credit exposures must agree to comply with, or already be subject to, the limits on executive compensation under the EESA; and
- Underlying credit exposures must not be cash or synthetic ABS.

Eligible borrowers will include all business entities or institutions organised under US law (including entities which have non-US parents) and US branches or agencies of foreign banks. The Federal Reserve is continuing to evaluate whether US-based investors that are organised outside the United States or invest through a non-US vehicle can qualify as eligible borrowers under the TALF.

Eligible borrowers will be able to request one or more three-year TALF loans on a monthly basis, specifying either a fixed-rate loan or floating-rate loan based on a spread over LIBOR. Borrowers will also pay a non-recourse loan fee. The collateral cannot be substituted during the term of the TALF loan and will not be subject to mark-to-market or re-margining requirements.

## Citigroup support and the Targeted Investment Program

Less than one month after Citigroup received USD 25 billion in TARP funds under the Capital Purchase Program, Treasury, the Federal Reserve and the FDIC agreed to guaranty a USD 306 billion real estate loan and security portfolio for the bank. The federal guarantee provides a term of ten years for residential assets and five years for non-residential assets. Citigroup will absorb the first USD 29 billion of losses on the portfolio


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and 10% of any subsequent losses; Treasury will absorb the next USD 5 billion of losses, the FDIC the following USD 10 billion and the Federal Reserve the remainder through a non-recourse loan. In exchange for the guarantee, Citigroup will issue USD 4 billion of 8% preferred stock to the Treasury and USD 3 billion of preferred stock to the FDIC.

As part of the guarantee package, Citigroup separately issued preferred shares paying an 8% dividend to Treasury and received an additional USD 20 billion infusion of TARP funds under the new Targeted Investment Program, the details of which were retroactively announced on 2 January 2009. Under the Targeted Investment Program, Treasury may make investments on a case-by-case basis to financial institutions it deems vulnerable to a 'loss of confidence' which could significantly disrupt financial markets. As a condition to the Treasury investment, Citigroup is required to comply with executive compensation restrictions, to implement the FDIC's mortgage modification program and cannot, without the consent of the Treasury, issue common stock dividends greater than USD 0.01/share for three years.

## Auto maker bridge loans and GMAC support

After Congress failed to reach consensus on an earlier auto rescue package, on 19 December Treasury extended USD 13.4 billion in short term financing from TARP funds to General Motors Corp. and Chrysler LLC, with an additional USD 4 billion in loans to follow in February 2009 (contingent upon the release by Congress of the remaining TARP funds), in exchange for warrants for non-voting stock equal to 20% of the maximum loan outstanding, executive compensation limits, dividend restrictions and other commitments. By 17 February 2009, the auto makers will be required to submit a detailed plan to achieve and sustain their respective long-term viability (evidenced by a positive net present value), international competitiveness and energy efficiency. If the President's designee determines that the auto makers have not taken the necessary steps to meet these goals by 31 March 2009, the loans will be called. The loan terms also set forth a number of non-binding restructuring targets on the auto makers, which include cutting their public debt by at least two-thirds, making half the payments they owe to union retirement funds in equity and negotiating new compensation and work rules competitive with those of the Japanese auto makers' US operations to be in place by 31 December 2009. General Motors and Chrysler will be required to provide to Treasury signed term sheets in respect of these restructuring targets by 19 February 2009.

On 29 December 2008, Treasury announced that it will use TARP funds to purchase USD 5 billion in 8% senior preferred equity in GMAC LLC, General Motors' financing arm. GMAC will also issue warrants for preferred (and not common) equity to Treasury in an amount equal to 5% of the preferred stock purchase, which will pay a 9% dividend if exercised. Treasury is also advancing USD 1 billion to General Motors to enable General Motors to participate in a rights offering at GMAC as part of its reorganisation as a bank holding company.

Treasury's support of General Motors, Chrysler and GMAC is being effected under the Automotive Industry Financing Program ('AIFP'), announced by Treasury on 31 December 2008. Under the AIFP, Treasury will have broad discretion to allocate TARP funds on a case-by-case basis in order to prevent significant disruption to the American automotive industry. Treasury may consider such factors as the importance of the institution to the production or financing of automobiles and whether a major disruption of the institution's operations would have a materially adverse effect on employment. Troubled auto parts suppliers and auto finance companies may now be eligible for TARP monies under this program.

## Whither TARP?

The Congressional Oversight Panel for Economic Stabilization, created under the EESA, issued a pointed critique about the application of TARP funds in a 10 December report. Among other points, the Panel questioned whether Treasury had an overall strategy to address the financial crisis, what meaningful steps it has taken to reduce foreclosures and what accountability it is demanding from recipients of TARP funds. Although Treasury defended itself in a formal response to the Panel's critique on 31 December 2008, Congressional leaders will likely attach stringent requirements to any release of remaining TARP funds, including more spending on foreclosure relief, increased mortgage lending and restrictions on executive bonuses and dividends. Whether the remaining USD 350 billion, however applied, will ultimately be sufficient to address the current economic challenges is, of course, a different matter.




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