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Treasury's Financial Stability Plan — What you Need to Know

By Christopher Cardinale and Stacey Gordon

This week, the Treasury Secretary Timothy Geithner announced the latest effort to solve the financial crisis with the Financial Stability Plan ("the Plan"). In his speech, the Secretary outlined the main principles of the Obama administration's multi-prong approach to stimulate the financial sector. Following the announcement, Secretary Geithner also spoke on Capitol Hill at the Senate Banking Committee's executive session on the new Plan. Neither Wall Street nor Congress reacted very positively because of the lack of details.

The Financial Stability Plan targets a number of areas to resurrect the credit markets. While the contours of the Plan are still very vague and many questions exist, the following summarizes what we know to date and highlights key areas of concerns that will need to be considered as the Plan develops.

Public-Private Investment Fund

Though not called a "bad bank," the new Public-Private Investment Fund probably will act like one and is designed to provide government capital and financing to leverage private capital that would buy up the "toxic assets." This would allow financial institutions to get their balance sheets in order while letting private sector buyers determine the price for previously illiquid assets. The program is described as placing private and public capital side-by-side to leverage $500 billion initially with the potential to expand to $1 trillion.

- *For the private markets to embrace this program, it is crucial that Treasury provide answers to questions on how pricing will be determined, and to address the structure for allocating risk and capital between the government and the private investors, as well as whether the government would provide any loss guarantees. Secretary Geithner indicated it may be several weeks before the details of the program are made available.*

Consumer and Business Lending

As a joint initiative with the Federal Reserve, $100 billion will be used to leverage up to $1 trillion for the Term Asset-Backed Securities Loan Facility (TALF), a program originally designed to restart the securitized lending market by providing financing to purchasers of pools of consumer loans in the secondary markets. Although first established in November 2008, TALF has yet to be implemented. As described in the Plan, TALF will be expanded to include commercial mortgage-backed securities (CMBS) and could later include residential mortgage-backed securities (RMBS).

- *Similar to the fund described above, the intent is to combine government assistance with private capital to activate the secondary loan markets. The pricing of the financing, the allowable borrowing ratios, and other important terms still need to be addressed.*

Capital Assistance Program

The Plan will institute a formal assessment or "stress test" of the nation's major banks to determine whether banks will be eligible to participate in the Capital Assistance Program (CAP). The stress test will target banking institutions with assets in excess of $100 billion and will be developed by the Federal Reserve, FDIC, OCC, and OTS. Following a stress test, a financial institution will then have access to the CAP, which may include as much as $1 trillion of additional capital. Treasury will receive a preferred security that can be converted into common equity. Any capital investments made by Treasury under this program will be placed in a separate entity, the Financial Stability Trust, which will be set up to manage the government's investments. CAP is intended to kick start the lending markets, with the hope of increasing access to capital to get credit flowing again.

Foreclosure Mitigation

As an initiative to help curb the housing crisis, Treasury will work with the Federal Reserve to commit $50 billion to reduce monthly payments and establish loan modification guidelines for government and private programs. All firms receiving federal funds will be required to participate in foreclosure mitigation plans. Though there are no available details on the foreclosure prevention program, it is anticipated that the plan will help drive down mortgage rates and spend as much as $600 billion for purchasing GSE-mortgage backed securities and GSE debt. The foreclosure prevention program would also build flexibility into the Hope for Homeowners program and the FHA to enable more loan modifications.

- *Treasury will need to address whether firms that do not receive federal funds, such as REMICS, will be able to participate in foreclosure mitigation. In addition, details are needed concerning how this program will work in conjunction with the existing FHA program.*

Small Business and Community Lending

Community banks will now be included in efforts to help the credit crisis. The SBA is planning to announce the launch of a Small Business and Community Banking Initiative to finance the purchase of AAA-rated SBA loans. The guarantee for SBA loans will also increase to 90%, and fees for SBA7(a) and 504 lending will be reduced.

In addition to the areas discussed above, the Financial Stability Plan includes the overarching principles of transparency and detailed reporting requirements. The difficulty in designing the Plan seems to be in striking the correct balance between greater government involvement and the need to improve the current inadequacies of the existing TARP program. It is evident that this Plan is a work in progress. The government will use a new website, www.financialstability.gov, to disclose more information on the Plan and provide greater transparency moving forward. Not only will the Administration need to hammer out the details, but additional Congressional appropriations and legislation may also be necessary. Goulston & Storrs' legal and legislative team will continue to monitor the Plan as it evolves.

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