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Loan Now or Else: Congress Proposes to "Fix" TARP

By: Peter G. Weinstock and Michael G. Keeley[1]

On January 9, 2009, Congressman Barney Frank introduced legislation entitled the "TARP Reform and Accountability Act of 2009" (the "Accountability Act"). The use of the word "accountability" speaks volumes regarding Congressman Frank's view that financial institutions should now answer for the enduring economic problems. Washington's favorite sport, searching for villains, has begun.

Apparently, Congressman Frank now blames all financial institutions because the economy continues to decline despite: statistics indicating that financial institutions have greater dollar volumes of loans on the books today than they did a year ago; the inability or unwillingness of borrowers to pay down or pay off their existing loans; and the FDIC's pressure on financial institutions to avoid brokered deposits or any other "wholesale funding" that would allow them to greatly enhance lending. Now, financial institutions who have received taxpayer money will be called on the carpet to increase their lending activities or explain why they have not done so.

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President Bush has requested the second tranche under the Troubled Assets Relief Program ("TARP"). Lawrence Summers, the proposed head of the National Economic Council, said in a letter to Barbara Boxer that President Obama plans to reform the oversight and toughen conditions for TARP funds. Whether or not the Accountability Act is adopted, the Obama administration can be expected to follow much of what it included. The FDIC has already issued a directive asking banks to track how TARP and other government programs have enabled them to increase "prudent lending" and reduce foreclosures. Accountability is coming, whether by law or political fiat.

Retroactive Effect. The Accountability Act's provisions are retroactive to October 3, 2008 for any financial institution that has received funding under the Capital Purchase Program ("CPP") that was adopted under TARP.

Reporting Requirements. The Accountability Act requires the bank regulatory authorities to modify the terms of the Call Reports and develop other methods for requiring financial institutions to publicly report their use of funds received under the CPP.

Ensuring Compliance. In addition to reporting, the Secretary of the U.S. Treasury ("UST") is required to adopt mechanisms to "ensure appropriate use and compliance" with the Accountability Act. For financial institutions that have not received funding under the CPP to date, the agreements between those institutions and UST must be modified from the current publicly available versions. Now, all of the agreements must dictate how the funds received will be used and must set benchmarks on how the funds will strengthen the financial system and enhance the availability of credit to the economy.

Regulatory Compliance. The federal banking regulatory agencies must adopt regulations establishing procedures to assure and monitor compliance with the Accountability Act. The procedures must be reviewed by the bank regulators at least annually.

Mergers and Acquisitions. No financial institution receiving funding under the CPP may engage in a merger or assume the deposits of any other financial institution unless the federal bank regulators consult with the UST, and after such consultation, determine that the merger will reduce risks to the taxpayer or the financial institution could have consummated the transaction without funding under the CPP. A significant benefit to taking government funding had been the potential to use such funds to grow through acquisitions. Such a strategy has now been thrown into uncertainty pending the adoption of any rules and regulations from the UST and the federal bank regulatory authorities as to how this requirement would be applied. Of course, the proposed legislation has not yet been adopted, which may provide a window to seek to obtain approval for transactions prior to any legislation that is adopted.

Executive Compensation and Corporate Governance. The Accountability Act increases the scope and restrictiveness of the executive compensation features of the Emergency Economic Stabilization Act of 2008 ("EESA"). The EESA had imposed limitations on the top five senior executive officers ("SEOs") of an institution receiving funding. First, the Accountability Act makes clear that the receipt of funding under CPP imposes the executive compensation requirements of the EESA and now the Accountability Act on the recipient. The Accountability Act then specifically requires a financial institution receiving funding under CPP to:

→ limit compensation incentives for SEOs to take unnecessary risks that threaten the value of the institution,

→ provide a clawback for any bonus or incentive compensation paid to a SEO based on financial statements that are later found to be materially inaccurate,

→ prohibit any golden parachute to an SEO,

→ prohibit any bonus or incentive compensation to the 25 most highly compensated employees, and

→ prohibit any compensation that would encourage manipulation of a financial institution's reported earnings.

The Accountability Act also prohibits any recipient from owning or leasing any private passenger aircraft. To the extent that the recipient already owns such an aircraft, it must demonstrate to the UST that it is taking reasonable steps to sell or divest such aircraft.

Regardless of a person's view of the utility of aircraft ownership by corporations, the proposed legislation would cause all corporate owners of private aircraft to take a loss by dumping such aircraft at fire-sale prices. There is no phase-out of such ownership. This brings back memories of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 requirement that financial institutions dump junk bonds onto a market that was already short of buyers.

The Accountability Act makes clear that it will apply to all parties receiving funding under the CPP regardless of whether the amount received is $300 million or less. Thus, the executive compensation provisions will now apply to all recipients.

Cops on the Beat. The Accountability Act authorizes the UST to require the attendance of an observer at all meetings of the board of an institution that has received assistance under TARP. There is no discussion of executive session for privilege purposes or excluding the observer when the board discusses the UST's interests.

Lending Increases. Each Call Report now must disclose the amount of any increase in new lending attributed to funds received under the CPP. If a financial institution cannot accurately quantify the effect of the funds received on new lending, it must report the total amount of its increased lending. Thus, financial institutions may feel obligated to increase their volume of loans regardless of whether they are comfortable with the creditworthiness of the borrowers to which such funds will be designated.

Warrant Enhancement. The warrant that the UST receives will be changed. Currently, the UST receives a warrant in publicly traded financial institutions equal to 15 percent of the amount of the Senior Preferred. The warrant is for common stock with an exercise price equal to the market value of the common stock based on the 20 trading days prior to issuance. For nonpublic companies, the warrant is equal to five percent of the Senior Preferred and there is a coupon of nine percent.

The warrant will remain 15 percent of the amount of the Senior Preferred, but will now entitle the UST to purchase nonvoting common stock up to a maximum amount of 15 percent of the issued and outstanding common stock or preferred stock having an aggregate liquidation preference equal to 15 percent of the Senior Preferred or a combination of the two. For public companies, the exercise price of the warrant will be based on the 15-day trailing average price or the economic equivalent of that price for nonpublic financial institutions. For private companies, the warrant now will be exercised at a penny or at the par value of the preferred stock. The UST may immediately exercise the warrants.

Private Companies and Subchapter S Institutions. The Accountability Act makes clear that funding under the CPP must be provided to privately held institutions and S corporations promptly. The funding would be on terms comparable to the terms applicable to institutions that receive funding prior to the enactment of the Accountability Act.

Ascendancy of Sheila C. Bair. The financial stability oversight board (the "FSOB") may now overturn any policy determination by the UST upon a two-thirds vote. The Accountability Act adds three additional members to the FSOB, including the Chairperson of the Board of Directors of the FDIC, Sheila C. Bair, and two persons appointed by President who do not work for the U. S. Government.

Title 2 – Foreclosure Relief. The Accountability Act requires the UST to develop, by March 15, 2009, a comprehensive plan to prevent and mitigate foreclosures on residential properties and for that plan to be approved by the FSOB. The plan must provide for the commitment of at least $40 billion and up to $100 billion for that purpose. The plan would be established on or before April 1, 2009 and must be implemented (at least to the tune of the $40 billion) by May 1, 2009. Otherwise, the UST must certify to Congress no later than May 15, 2009 why it had failed to do so.

Congressman Frank's intention clearly is to require the money to be spent on foreclosure relief. In addition, it is his desire to put Sheila Bair and her belief in principal forgiveness at the crux of any plan to be developed.

The plan must:

- prevent and mitigate foreclosures on owner-occupied residential properties, and
- leverage private capital to the maximum extent possible.

The plan may provide for funds to be concentrated in areas hardest hit.

The Accountability Act presupposes alternatives to the UST's plan. Specifically, the program alternatives are:

- the systemic foreclosure prevention and mortgage modification program,
- the reduction of HOPE for Homeowners Act program costs by providing for coverage fees and ensuring the affordability of interest rates of mortgages insured under the HOPE for Homeowners,
- direct lending to homeowners, which may be used only to reduce the outstanding second-lien mortgage debt in order to facilitate loan modifications including the reduction in the principal amount of the second-lien mortgage acquired by the UST,
- the UST making payments to servicers who implement modifications to mortgages that meet UST's new guidelines; and
- entering into contracts with the FDIC and entities that had been selected as contractors under the EESA to effect the purchase of whole loans for the purpose of modifying or refinancing the loans.

The Systematic Foreclosure Prevention and Mortgage Modification Program. The Systematic Foreclosure Prevention and Mortgage Modification Program (the "Alternative Program") would be established by UST in consultation with the Chair of the FDIC and the Secretary of HUD that would provide lenders and loan servicers with compensation to cover the administrative costs for each loan modified according to the intended standards and provide for loss sharing or guarantees for losses incurred if the modified loan subsequently re-defaults.

The Alternative Program is limited to loans to homeowners who have made a specified minimum number of payments on their modified mortgage. There would be a standardized net present value analysis for lenders and servicers comparing the expected benefit to modifying the loan versus foreclosing on the loan. The standard assumptions would be required to ensure consistent standards for affordability based on the borrower's mortgage-related expenses to gross income.

Under the Alternative Program, participants must have a systematic review of all loans under their management to subject each loan to the standard net present value test to determine if the loan is a candidate for modification and, if so, to offer modifications for all loans that pass the test. In the event that an institution fails to undertake such a systematic review and to carry out the modifications required, then they would be disqualified from further participation in the program.

The modifications may take the form of reductions in interest rates and fees, changes to extending the term or amortization, forbearance or forgiveness of principal or other similar modifications.

In order to qualify for loss sharing, the modification must reduce the payment on the loan by at least 10 percent. In addition, there would be an eight-year limit on loss-sharing payments from UST.

Safe Harbor. There also is a servicer safe harbor that provides that a servicer may not be liable for entering into a loan modification or workout plan with respect to any mortgage plan that meets certain criteria. Those criteria include a default on the payment of a mortgage or a foreclosure is reasonably foreseeable for an owner-occupied home loan, and the servicer reasonably believes that the recovery, pursuant to the modification or other loss mitigation action, will exceed on a net present value the recovery realized through foreclosure. Any party bringing suit against a servicer who loses such case must pay the servicer's costs.

Reporting. The Alternative Program provides for regular reporting to the UST regarding the servicer's modification activities. The ESOB must report to Congress not later than July 1, 2009 regarding the actions taken and the effectiveness of such actions.

Commercial Real Estate Lending. The Accountability Act specifically clarifies that the UST has the authority to support the availability of commercial real estate loans, including through purchase of asset-backed securities, directly or through the Federal Reserve Board.

FDIC Insurance. The Accountability Act makes the increase in FDIC insurance to $250,000 remain in place until 2015 and thereafter will be adjusted for inflation.

The FDIC is permitted to provide assistance in order to avoid systemic risk. The FDIC now specifically has the authority to charge special assessments to cover such costs. For the first time, such assessments may be leveled on depository institution holding companies.

Hope for Homeowners.

Costs. The Accountability Act eliminates the three percent up-front premium associated with such loans. It also reduces the annual premium to arrange between 55 and 75 basis points. There also is a provision for the possibility of reducing or discontinuing such premiums over time. The maximum loan-to-value ratio permissible for a modification under the program is increased to 93 percent from 90 percent for borrowers above certain mortgage debt to income ratios. In addition, the changes eliminate the government's profit sharing from the increase in market value of the home at the time of the refinancing. The government still would receive 50 percent of the equity created by the refinancing as an exit fee. Payments to the ESOB may establish a payment to servicers for every loan insured under the Hope for Homeowners program.

Home Buyer Stimulus. Like King Canute trying to hold back the tides, Congressman Frank is trying to reduce declining home values. Title 6 of the Accountability Act provides for the UST to adopt a stimulus to increase demand for home purchases and reduce the unsold inventories of residential properties. The UST is to do so by ensuring the availability of affordable interest rates on mortgages and by purchasing obligations of Fannie Mae, the Federal Home Loan Mortgage Corporation and any Federal Home Loan Bank.

Time to Back Out? The Accountability Act provides that, subject to consultation with the appropriate bank regulator, any financial institution that has received funding under CPP can repay such funds even if it has not engaged in a qualified offering. Accordingly, the Accountability Act enables financial institutions to opt out of its provisions to the extent that they have the funds to redeem the Senior Preferred provided for under the CPP.