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September 22, 2008

TO: Commercial Mortgage Securities
Association

FROM: Scott Sinder
Rhonda Bolton

RE: Summary of Legislative Proposals to Allow U.S. Treasury Department to
Purchase Mortgage-Related Assets

Within a three-day span, three separate legislative proposals have been introduced to authorize the Treasury Department to buy up to \$700 billion in distressed mortgages or mortgage-related assets, both commercial and residential. The Treasury Department's proposal was unveiled on September 20, 2008, and was quickly followed by separate proposals from U.S. Senate Banking, Housing, and Urban Affairs Committee, and the U.S. House of Representative Financial Services Committee on September 22, 2008. The discretion of the Secretary of the Treasury as to what is purchased, how, and when is fairly broad under all three proposals, although the broadest discretion is sought by Treasury's bill. The purchasing power lasts approximately two years under the Treasury and Senate proposals, and slightly more than one year under the House bill, although none of the proposals constrains the time for holding the purchased assets.

The Treasury proposal contains no other substantive or procedural constraints, but the House and the Senate bills would impose both. Of particular interest, the Senate bill would require selling companies to pledge conditional stock assets which would be used by Treasury to cover any loss the government has when it sells the assets it purchased from that entity. The House bill does not require a stock pledge but would require selling companies to abide by a number of new requirements including criteria for executive compensation that would preclude incentives for risky behavior, "golden parachutes," and incentive packages for senior executives when a company must restate earnings restatements (the Senate bill contains similar executive compensation restrictions); requirements that would allow shareholders holding at least 3% to

put candidates on the ballot for board of director elections; and requirements to allow shareholders to have non-binding votes on executive compensation.

Both the House and the Senate bill also would impose various procedural and oversight safeguards on the Department's exercise of these new powers, including:

- oversight and audits by the Comptroller General, Congressionally appointed boards, and in the case of the House bill, a new Inspector General;
- frequent reports to Congress, including the provision of audited financial statements regarding Treasury's activities under the program;
- establishment of conflict of interest rules to govern situations in which asset managers hired to assist Treasury also have positions in the assets that Treasury is purchasing (Senate bill);
- requirement that Treasury use competitive bidding to award asset management contracts under the program (House bill); and
- requirement that Treasury use "market mechanisms" such as reverse auctions to establish purchase prices for the troubled securities (House bill).

More detailed summaries of each bill are provided below.

Treasury Department Proposal

Treasury's legislative proposal, only three pages in length, will do the following:

- Give the Treasury Department Secretary authority to purchase "mortgage-related assets" from any financial institution headquartered in the United States, on terms and conditions as determined by the Secretary. "Mortgage-related assets" are defined as "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before September 17, 2008." In exercising this authority, the Secretary is to "take into consideration" means for providing stability to the financial markets and banking system, and for "protecting the taxpayer;"
- Give the Secretary complete discretion as to purchasing, managing, or selling any mortgage-related assets under the legislation, or exercising any rights received in connection with the mortgage-related assets. The bill explicitly makes all Treasury Department actions in connection with this initiative non-reviewable by courts or other administrative agencies;

- Authorize the issuance of up to \$700 billion in Treasury securities to finance purchases under the legislation;
- States that the costs of asset purchases under the legislation will be determined as provided under the Credit Reform Act of 1990. The Credit Reform Act of 1990 was enacted to provide a more realistic picture of the cost of U.S. government direct loans and loan guarantees and requires that “credit subsidy cost” be accounted for, which is the net present value of the estimated long-term cost to the government for these credit activities, exclusive of administrative expenses. It is not clear from the bill whether this provision defines the price that Treasury will offer for assets under the legislation or whether this is merely a direction to Treasury as to how it will record purchases on its books.
- Require Treasury to report to Congress within three months of the initial purchase, and semi-annually thereafter, regarding the activities undertaken pursuant to Treasury’s authority under the legislation; and
- Sunsets Treasury Department authority to purchase assets two years from the legislation’s enactment date, although Treasury may continue to own, manage and dispose of assets after the sunset date.

The Treasury bill contains no other substantive provisions or details; for example, the bill itself does not specify that Treasury’s authority will be limited to purchasing “troubled” or non-performing assets, nor does it explicitly explain how it will determine what it will pay for the assets it will purchase. However, a “Fact Sheet” published by Treasury provides more editorial details, emphasizing that the purchase of troubled assets is the purpose of the plan, and explaining that the price of asset purchases will be established through “market mechanisms where possible, such as reverse auctions.”

U.S. Senate Banking, Housing, and Urban Affairs Committee Proposal

In response to Treasury’s proposal, the U.S. Senate Banking Committee released a Discussion Draft of its own bill that would still give Treasury discretion to purchase “troubled assets from any financial institution,” but with significantly more oversight from Congress. The Senate’s bill contains general provisions that apply to all aspects of the asset purchase program, and several that apply specifically to the residential mortgage market. The general provisions do the following:

- Establishes an Office of Financial Stability to implement the program, and establishes a separate Inspector General for this Office, which is directed to report directly to Congress on a quarterly basis regarding the Office’s activities;
- Specifically states that Treasury is authorized to purchase “troubled assets,” defining those as “residential or commercial mortgages, and any securities, obligations, or other instruments that are based on or related to such

mortgages, that in each case were originated or issued on or before March 14, 2008; and upon the determination of the Secretary, in consultation with the Chairman of the Board of Governors of the Federal Reserve System, any other financial instrument, as the Secretary determines necessary to promote financial market stability;”

- States that troubled assets are to be purchased from “financial institutions,” defined as “any institution, including banks, savings associations, credit unions, securities broker and dealers, and insurance companies, having significant operations in the United States; and upon the determination of the Secretary, in consultation with the Chairman of the Board of Governors of the Federal Reserve System, any other institution that the Secretary determines necessary to promote financial market stability.
- Conditions the Secretary’s ability to buy a troubled asset on the Secretary receiving “contingent shares” in the financial institution from which such assets are to be purchased equal in value to the purchase price of the assets to be purchased,” or contingent debt instruments if the entity is not publicly traded on a national securities exchange, in an amount equal to 125% of the difference between the price the Secretary pays for the troubled assets and the disposition price of the assets. Additionally, if, after the purchase of troubled assets from a financial institution the amount the Secretary receives in disposing of the assets is less than the amount that the Secretary paid for such assets, the contingent shares received by the Secretary will automatically vest to the Secretary in an amount equal to 125% percent of the difference divided by the average share price of the financial institution from which such assets were purchased during the 14 business before such purchase.
- Requires that, before establishing the plan, the Secretary make formal findings that the program is necessary to promote stability or prevent disruption to financial markets or the banking system, and to protect taxpayers;
- Establishes an “Emergency Oversight Board” responsible for reviewing Treasury’s actions under the program, chaired by the Federal Reserve Chairman, and with members from the heads of the FDIC and SEC, and two members to be appointed jointly by the leadership of the House and Senate;
- Requires Treasury to report monthly to Congress regarding its activities under the bill, including a written financial statement describing matters such as valuation methods used for each transaction, and copies of all agreements made or renewed. Treasury is also to submit audited financial statements to Congress for the program, and audits are to be done by the Comptroller General;
- Directs the Secretary to develop rules to address conflicts of interest in the program administration, including conflicts that could arise because Treasury

has hired advisors or asset managers to assist with the program who also hold positions in the troubled assets being sold to Treasury;

- Directs Treasury to require that entities seeking to sell assets through the program meet “executive compensation standards” that limit incentives for executives to take risks that the Secretary deems to be inappropriate or excessive; contain claw-back provisions for incentive compensation paid to a senior executive based on earnings, gains, or other criteria that are later proven to inaccurate; and contain limits on severance that the Secretary deems to be “appropriate in the public interest in light of the assistance being given to the entity;”
- Authorize the issuance of up to \$700 billion in Treasury securities to finance purchases under the legislation;
- Makes the Secretary’s actions reviewable by courts under the “arbitrary and capricious” standard of administrative law;
- Sunsets Treasury Department authority to purchase assets on December 31, 2009, although Treasury may continue to own, manage and dispose of assets after the sunset date. Treasury may also request to extend its authority, but the extension may go no later than two years after the bill’s enactment, and the extension request must be accompanied by a justification;
- The bill’s “credit reform” provisions specifying how the purchases are to be valued are not included; there is a bracket indicating that this provision is to be supplied by the Senate Budget Committee;
- Directs the Comptroller General to undertake a study to determine the extent to which leverage and sudden deleveraging of financial institutions was a factor in the current crisis, and to assess whether the troubled asset purchase program has stabilized the financial market and protected taxpayers;

The provisions that apply solely to residential mortgages including the following:

- A “cram down” provision that allows bankruptcy courts to modify the terms of residential mortgages so that borrowers can get the mortgages on their first and second homes reduced to the market value;
- Requirement that Treasury shift the whole mortgages and residential MBS it purchases to the FDIC to manage, and requirement that the FDIC modify those loans where possible. Requirement that other federal agencies holding or controlling mortgages or residential MBS to modify whenever possible; this would include FHFA, which controls Fannie and Freddie’s portfolios, and the Federal Reserve Bank of NY, which owns a portfolio of mortgages acquired from Bear Stearns;.

- Requirement that 20% of the profit of any assets purchased and sold by the Treasury through this program go to the Affordable Housing Fund, which previously were to be financed by the GSEs;

House Financial Service Committee Bill

Like the Senate's bill, the House's Discussion Draft would give Treasury discretion to purchase "troubled assets from any financial institution," but with significantly more oversight from Congress. The House bill contains general provisions that apply to all aspects of the asset purchase program, and several that apply specifically to the residential mortgage market. The general provisions do the following:

- Allows Treasury to purchase "troubled assets," defined as "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before September 17, 2008, the purchase of which the Secretary determines promotes financial market stability; and, upon the determination of the Secretary in consultation with the Chairman of the Board of Governors of the Federal Reserve, any other financial instrument, the purchase of which the Secretary determines necessary to promote financial market stability."
- Allows "troubled assets" to be purchased from "financial institutions," defined as "any institution including [,but not limited to,] banks, savings associations, credit unions, broker-dealers, and insurance companies organized and regulated under the laws of the United States or any State, territory, or possession of the United States, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Marianas Islands, Guam, American Samoa, or the United States Virgin Islands, and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government."
- Direct that Treasury's decisions be made in consultation with the Federal Reserve, FDIC and HUD; and that Treasury's decisions take "into consideration" providing stability to markets and protection to taxpayers, and the strength of the financial institution from which assets would be purchased in assessing whether the purchase would represent the most efficient use of funds;
- Require Treasury to provide a plan detailing its expected use of funds for administrative expenses under the program, and require a report to Congress 60 days after the first exercise of authority under the legislation and every 90 days thereafter;
- Authorize the issuance of up to \$700 billion in Treasury securities to finance purchases under the legislation;

- Sunsets Treasury Department authority to purchase assets two years from the legislation's enactment date, although Treasury may continue to own, manage and dispose of assets after the sunset date.
- Requires Treasury to use competitive bidding to award contracts to asset managers;
- Directs Treasury to require that entities seeking to sell assets through the program meet "executive compensation standards" that limit incentives for executives to take risks that the Secretary deems to be inappropriate or excessive; contain claw-back provisions for incentive compensation paid to a senior executive based on earnings, gains, or other criteria that are later proven to inaccurate; and prohibit payment of severance packages to executives during a period when earnings must be restated;
- Directs Treasury to use "market mechanisms" such as reverse auctions in making asset purchases;
- Provides for oversight and auditing of Treasury's activities under the program by the Comptroller General;
- Also provides for oversight by a Congressionally appointed panel;
- Where Treasury makes a direct purchase from an individual financial institution, during the time Treasury holds an equity position Treasury must require the institution to allow any shareholder(s) holding a 3% or greater interest in the institution to access the proxy solicitation and shareholder voting processes to allow nomination of a person for the board of directors; allow the institutions to afford all shareholders a chance to cast a non-binding vote on executive compensation; and prohibit the payment of severance to senior executives; and
- Provides that Treasury's actions under the program are "committed to agency discretion," which generally means they are not reviewable by courts.

Among the most significant provisions applicable to residential mortgages is a provision that allows bankruptcy courts to modify residential mortgage terms.