



Berkeley Center for Law,
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**A Guide to the Financial Bailout Legislation
(The Emergency Economic Stabilization Act of 2008)**

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A Guide to the Financial Bailout Legislation

by John Patrick Hunt

This guide covers the “bailout” provisions (Division A) of the Emergency Economic Stabilization Act of 2008. It summarizes each major provision (in Roman font) and offers specific comments on selected sections (in italics).

All references without U.S.C. citations are to the (the “Act”). References to the “Secretary” are to the Secretary of the Treasury.

1. General Nature and Scope of the Relief Program

The Secretary of the Treasury is authorized to purchase “troubled assets” from “any financial institution.” (§ 101(a)(1)).

Dollar Size: Up to \$700 billion, measured by purchase price of assets. (§ 115)

Treasury’s initial proposal did not define how this critical number is calculated. We now know that the \$700 billion is applied to actual prices paid, rather than notional amounts of the assets or to the “cost” of the program, as calculated under procedures provided elsewhere in the Act and discussed below.

The Act provides for the purchase authority to be increased incrementally, in three “tranches.” Initial authority is \$250 billion, expandable to \$350 billion upon written certification by the President to Congress that the Secretary “needs to exercise” the additional authority. Authority expands to \$700 billion if (a) the President “transmits to Congress a written report detailing the plan of the Secretary to exercise” the additional authority and (b) Congress *does not* enact a joint resolution within 15 calendar days disapproving the additional authority. (§ 115(a),(c)).

Despite the lengthy tranching provisions, including several pages defining the accelerated procedure that is to be followed (including calling Congress back into session) in connection with the resolution of disapproval, these procedures are widely viewed as meaningless. Treasury reportedly plans to exercise its maximum authority in a very short space of time and it seems likely that the President would veto any resolution of disapproval that Congress does enact.

The debt ceiling is increased by \$700 billion, to \$11.315 trillion. (§ 122).

Who Can Sell: Any “financial institution,” defined as “any institution ... established and regulated under the laws of the United States or any State ... and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government.” (§3(1)(5)). However, assets may be purchased from “foreign financial authorities” or “central banks” if held “as a

result of extending financing to financial institutions that have failed or defaulted on such financing.” (§ 112)

Contrary to some media accounts, this would seem to include both hedge funds (at least domestic ones), and, at a minimum, foreign banks with domestic affiliates. The need for the exclusion of foreign central banks and institutions owned by foreign governments suggests the broad sweep of the definition.

What Can Be Sold: “Troubled assets” – residential and commercial mortgages and securities based thereon or related to them, expandable upon consulting with Fed Chair to “any other financial instrument .. the purchase of which is necessary to promote financial market stability.” (§3(1)(9))

The “based thereon or related to” would seem to draw in derivatives based on mortgage instruments. AIG’s large book of subprime-mortgage-related credit-default swaps (CDS) is seen as a significant factor in its collapse.

Treasury Authority to Act through Others: The Secretary has “direct hiring authority” (§ 102(b)(1)) for personnel to administer the Act, and may also carry out its mission by “entering into contracts” (§ 102(b)(2)) and “designating financial institutions as financial agents of the Federal Government.” (§ 102(b)(3))

According to an October 6 press release, the asset managers who will actually purchase and decide to sell the assets under the program will be financial institutions designated as financial agents. The Treasury states that these institutions are not contractors.

Sunset of Authority: Authority to purchase assets expires on December 31, 2009, but can be extended by the Secretary to two years after date of enactment “upon submission of a written certification to Congress,” which must include “a justification of why the extension is necessary to assist American families and stabilize financial markets, as well as the expected cost to the taxpayers for such an extension.” (§ 120).

In effect, the Secretary’s authority is for two years from enactment: until October 3, 2010.

2. Procedures for Purchase and Sale of Assets

Although the Act prescribes various considerations for the Secretary to take into account in purchasing assets, it is clear that the Secretary’s discretion in this area is very broad. Discretion in selling assets is limited in that the Secretary must seek maximum return on investment to the government.

Price Paid: Secretary is to use authority “in a manner that will minimize any potential long-term negative impact on the taxpayer, taking into account the direct outlays, potential long-term returns on assets purchased, and the overall economic benefits of the program, including

economic benefits due to improvements in economic activity and the availability of credit.” (§ 113(a)(1))

Secretary must make purchases “at the lowest price that the Secretary determines to be consistent with the purposes of this Act” (§ 113(b)(1)) and “maximize the efficiency of the use of taxpayer funds by using market mechanisms, including auctions or reverse auctions, where appropriate.” (§ 113(b)(2)). If no auction, Secretary must “pursue additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset.” (§ 113(c)).

It is rather clear that the Secretary may buy assets at prices above market— and even at prices above the Secretary’s assessment of fair value – as long as the high price is justified by other considerations. There is no requirement to use any particular method of purchasing assets, and prices must merely “reflect” asset values.

Equity: Subject to a de minimis exception not to exceed \$100 million (§ 113(d)(3)(A)), Secretary must receive a warrant giving the right to receive nonvoting common or preferred stock, or common stock as to which the Secretary agrees not to exercise voting power (§ 113(d)(1)(A)). If the institution does not have securities that are traded on a national securities exchange, Secretary may take a “senior debt instrument” instead of equity. (§ 113(d)(1)(B))

The securities must provide for “reasonable participation by the Secretary, for the benefit of taxpayers, in equity appreciation in the case of a warrant or other equity security, or a reasonable interest rate premium, in the case of a debt instrument,” (§ 113(d)(2)(A)(i)) and “provide additional protection for the taxpayer against losses from sale of assets by the Secretary” (§ 113(d)(2)(A)(ii)). Exercise price is to be “set by the Secretary, in the interest of the taxpayers.” (§ 113(d)(2)(E))

Although the requirement to take equity is mandatory in the circumstances in which major asset purchases will be made, it seems difficult to require the Secretary to make this requirement particularly meaningful. For better or worse, the drafters don’t seem to have made a serious effort to cabin the Secretary’s discretion here, requiring only “reasonable participation” in appreciation, without further elaboration on the term,

Sale: Secretary can sell troubled assets “at any time, upon terms, conditions, and at a price determined by the Secretary” (§ 106(c)). No deadline for sale (§106(d)).

Discretion to sell does seem to be limited by the provision that Secretary must sell assets “at a price that the Secretary determines, based on available financial analysis, will maximize return on investment for the Federal Government. (§ 113(a)(2)). Only financial considerations may enter into the decision regarding timing of sale: Secretary is to hold “until such time as the Secretary determines that the market is optimal for selling such assets, in order to maximize the value for taxpayers.” (§ 113(a)(2)(A))

Unlike the purchase provisions, the sale provisions attempt to limit the Secretary's discretion to considering only the effect on the fisc, although the broad language of § 106(c) suggests that the Secretary will have loosely limited discretion here as well.

Recoupment from Financial Industry of Treasury Losses: After five years, OMB (in consultation with CBO) is to “submit a report to Congress on the net amount within” the Troubled Asset Relief Program (TARP), and “[i]n any case where there is a shortfall, the President shall submit to a legislative proposal that recoups from the financial industry an amount equal to the shortfall in order to ensure that the [TARP] does not add to the deficit or national debt.” (§ 134)

This provision seems to have attracted relatively little notice, perhaps because the order to the President to make a submission to Congress with these specific characteristics seems constitutionally dubious.

Purchase Guidelines: Secretary has 45 days to “publish program guidelines” governing “mechanisms for purchasing troubled assets, methods for pricing and valuing troubled assets, procedures for selecting asset managers,” and “criteria for identifying troubled assets for purchase.” (§ 101(d)). The Secretary has two business days from the first purchase of securities to publish guidelines. *Id.*

Secretary “shall take such steps as may be necessary to prevent unjust enrichment of financial institutions participating in a program established under this section, including by preventing the sale of a troubled asset to the Secretary at a higher price than what the seller paid to purchase the asset.” (§ 101(e))

The language is a bit difficult to parse here, but it seems likely that the Secretary may purchase troubled assets at price higher than what the seller paid, as long as the Secretary determines that that does not amount to “unjust enrichment.”

Considerations: Secretary is to be guided by nine “considerations,” with no indication of how to weigh them. The considerations include “protecting the interests of taxpayers,” “providing stability and preventing disruption to financial markets,” and “help[ing] families keep their homes and ... stabiliz[ing] communities,” (§ 103(1)-(3)). To some extent, the considerations appear mutually contradictory, e.g., considering the “long-term viability” of a financial institution in deciding whether to purchase from that institution (§ 103(4)) while “ensuring that all financial institutions are eligible to participate” (§ 103 (5)).

A major theme is clarifying Treasury's authority to buy from particular institutions other than large banks, such as smaller banks affected by devaluation of Fannie and Freddie preferred stock (§103(6)), municipalities (§103(7)), and pension funds (§ 103(8)). There is also an instruction to consider “the utility of purchasing other real estate owned and instruments backed by mortgages on multifamily properties.” (§ 103(9)).

Most of these considerations don't really have anything to do with articulated reasons for massive government financial interventions and amount to bailing out bad investments. Given that there is no guidance on the weight to be given to the competing considerations, this provision seems significant, if at all, in clarifying that the Secretary is authorized to make purchases for reasons that may not be closely related to the systemic bailout.

Conflicts of Interest: Secretary is to “issue regulations or guidelines necessary to address and manage or to prohibit conflicts of interest” in connection with the authority granted (§ 108(a)), and is to do so “as soon as practicable after the date of enactment of the Act.” (§108(b)).

Adopting conflict-of-interest rules isn't to stand in the way of making purchases. The Secretary can make purchases before final conflicts rules are in place, and it seems highly likely that that will happen. The Secretary issued interim conflicts rules for contractors performing services under the program on October 6, 2008. It is unclear that these rules cover the asset managers that will be in charge of the securities Treasury acquires, as a separate release explaining the process for choosing these managers explains that they will be “financial agents” and not “contractors.”

3. **Insurance Program**

The Act provides for an insurance program under which financial institutions can choose to receive federal guarantees for troubled assets. The insurance program apparently is not expected to become a significant element of the relief package adopted by the Secretary.

If the Secretary exercises authority to purchase troubled assets, then the Secretary must “establish a program to guarantee troubled assets originated or issued prior to March 14, 2008.” (§ 102(a)(1)). Any financial institution is eligible for a federal guarantee (§ 102(a)(3)); the Secretary is to charge participating financial institutions premiums for the insurance program (§ 102(c)(1)). , Premiums “shall be set by the Secretary at a level necessary to create reserves sufficient to meet anticipated claims, based on an actuarial analysis, and to ensure that taxpayers are fully protected.” (§ 102(c)(3)). Payouts under the insurance program are to be made from a fund into which premiums are deposited. (§102(d)).

Authority to purchase is reduced by the difference between “the total of the outstanding guaranteed obligations and the balance in the Troubled Assets Insurance Financing Fund.” (§ 102(c)(4)).

It is unclear what happens if payout obligations under the insurance program exceed the premiums that have been collected at any given point. Given the current state of distress, it seems that premiums might have to be set at very high levels to accumulate sufficient reserves to fund payouts in the near term. In light of this issue, the fact that purchase authority is reduced by the amount of assets insured, and the fact that the Secretary's original proposal provided only

for sale and not insurance, it does not appear that the insurance program is expected to be an important part of the federal effort.

4. Executive Compensation

The Act provides two different sets of executive-compensation rules. The first set covers institutions from which the Secretary purchases assets directly, without an auction. Although it is not entirely clear, these rules may not impose any meaningful restrictions. The second set covers institutions from which the Secretary purchases more than \$300 million in assets at auction, and prohibits new golden-parachute packages and eliminates deductions for executive pay over \$500,000.

Direct purchases: When Secretary purchases assets directly from an individual financial institution (i.e., not at auction) and receives “meaningful equity or debt position” in the financial institution, the institution must meet executive compensation and corporate governance standards: “limits on compensation that exclude incentives for senior executive officers to take unnecessary and excessive risks,” clawbacks of pay based on “materially inaccurate” financials, and a prohibition on making “golden parachute payments” while Secretary holds debt or equity. (§ 111(b)(1), (2)). “Senior executive officers” are the top five highest-paid officers. (§ 111(b)(3)).

The prohibition here is on “making” golden parachute payments. (“Golden parachute payments” are not defined in the Act, but “excess parachute payments” are defined in the Internal Revenue Code as payments in excess of three times the executive’s average compensation for the past five years (26 U.S.C. § 280G)). It is not clear whether golden parachute payments can be deferred until such time as the Secretary no longer holds a debt or equity position in the company. If they can be deferred, then it is unclear that this provision imposes any meaningful restriction.

Purchases at Auction: A separate set of rules applies when the Secretary purchases over \$300m of assets at auction from an institution:

The institution may not enter into new employment contracts with senior executive officers that include a golden parachute in the event of involuntary termination or bankruptcy. (§ 111(c)). Moreover, the institution may not deduct annual pay over \$500,000 to the CEO, CFO, and three other highest-paid corporate officers in the period the authorities under the Act are in effect. (§ 302(a)). Moreover, the golden-parachute provisions of § 280G of Internal Revenue Code apply to payments made to CEO, CFO, and three other highest-paid executive officers as a result of involuntary termination, bankruptcy, liquidation, or receivership. (§ 302(b)).

This means that payments to the executive are nondeductible to the extent that they exceed three times the executive’s average compensation over the past five years. 26 U.S.C. § 280G.

There are additional provisions apparently intended to ensure that the no-deductibility rule cannot be avoided by deferred compensation arrangements. (§ 302 *passim*).

The no-parachute provision sunsets when the “authorities under section 101(a)” are no longer in effect (probably October 3, 2010) (§ 111(d)), and the tax provision sunsets at the end of the last year the authority is in effect, (§ 302; 26 U.S.C. § 162(m)(5)(C)), so it probably will sunset December 31, 2010.

5. FDIC-Related Provisions

The Act temporarily increases the FDIC insurance limit (without a corresponding increase in amounts banks are assessed to pay for the program), apparently extends FDIC powers to pursue entities that make false claims of FDIC backing, and nullifies certain contract provisions that could hinder FDIC-brokered mergers.

Insurance Limit Increase: FDIC insurance limit is raised to \$250,000 from \$100,000 through December 31, 2009. (§ 136(a)(1)). The increase is not to be considered in setting assessments on banks. (§ 136(a)(2)). The FDIC is authorized to borrow without limit from the Treasury through December 31, 2009 (§ 136(a)(3)). A corresponding increase is adopted for the NCUA, the FDIC counterpart for federal credit unions. (§ 136(b)).

This provision effectively abandons the longstanding assertion that the FDIC is a self-funding entity, at least for the duration of the crisis.

False Representations of FDIC Backing: In Section 126, the FDIC Act is amended to prohibit falsely “represent[ing] or imply[ing]” by the use of the FDIC name or symbol “that any deposit liability, obligation, certificate, or share is insured or guaranteed” by the FDIC 12 U.S.C. § 1828(a)(4)(A). Also prohibits “knowingly misrepresent[ing]” that instruments are insured. *Id.* §1828(a)(4)(B).

Provides for FDIC enforcement jurisdiction over entities that are not subject to federal banking law, and provides for the FDIC to enforce where an entity is subject to federal banking law and the relevant agency does not take action within 30 days of receiving a recommendation for action from the FDIC. *Id.* §1828(a)(4)(C)-(E).

The FDIC or other federal banking regulator is authorized to issue a temporary order requiring the immediate cessation of violations of the false-representation provision pending completion of administrative proceedings, and to assess civil money penalties. *Id.* § 1818(c)(4). Civil penalties for violations of the new prohibitions are permitted. *Id.* § 1818(c)(4).

The amount of civil penalties is somewhat unclear but may be \$1 million per day for nonbanks – an important category as this section seems to be aimed at unregulated companies that falsely asserts that investments with the company are FDIC-insured. The Act provides that parties that violate the misrepresentation provisions are subject to penalties “as set forth in” 12 U.S.C. §

1818(i). Section 1818(i) provides for three tiers of penalties: \$5,000/day for simple violations; \$25,000/day for violations that are part of pattern of misconduct, causes or is likely to cause more than a minimal loss, or results in a pecuniary gain or other benefit to the party responsible for the violation; and \$1 million /day for knowing violations that result in a substantial loss to a depository institution or a substantial gain for the party responsible for the violation. Although all three levels of penalty apply to “insured depository institutions and institution-affiliated parties,” Section 1818(c), as amended by the Act, provides for penalties for persons who don’t fall into either category (for example, companies that falsely hold themselves out as banks).

The statute expressly provides that in the case of persons not affiliated with depository institutions, the FDIC or other agency is not “required to demonstrate any loss to an insured depository institution.” The net result of abolishing this element is that the \$1 million daily fine apparently applies to any person who is not affiliated with a depository institution and who commits a knowing violation. Although such a person could argue that it is not subject to any penalty because it does not fit into any of three tiers defined in § 1818(i), it seems clear the provision is intended to impose penalties on such persons.

Contracts Hindering FDIC-Assisted Mergers: Denies enforcement to confidentiality or standstill agreements that would hinder FDIC-brokered transactions. Specifically, no provision is enforceable if it affects or limits the ability of any person to acquire, offer to acquire, or use previously disclosed information in acquiring of an insured depository institution in a transaction in which the FDIC is exercising its power under 12 U.S.C. § 1821 (such as the ability to act as a conservator/receiver) or § 1823 (such as the ability to assume liabilities or issue guarantees to facilitate a merger or consolidation). (§ 126(c))

6. Foreclosure Mitigation/Management Guidelines

The Act has a number of provisions apparently intended to facilitate voluntary workouts of distressed mortgages that either (a) are purchased by the Secretary (or back securities purchased by the Secretary) or (b) are on residential properties managed by the federal government. No details are prescribed to the Secretary, and it appears that Congress contemplates only “win-win” restructurings – not deals that take from lenders or investors to give to borrowers.

Mitigation of Foreclosure on Mortgages/MBS Acquired by Secretary: To the extent the Secretary acquires mortgages or MBS, the Secretary “shall implement a plan that seeks to maximize assistance for homeowners,” and “encourage the servicers of the underlying mortgages, considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program ... or other available programs to minimize foreclosures.” (§ 109(a)). In addition, Secretary “may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.” (§ 109(a))

This provision is rather opaque. The “considering net present value to the taxpayer” language seems intended to encourage (though not require) the Secretary to do only workouts that, broadly speaking, benefit the lender as well as the borrower. The (redundant) language about “prevent[ing] avoidable foreclosures” emphasizes the limits on any assistance to be provided. The absence of detail about “assistance for homeowners” throughout the bill suggests that this is not a serious part of the legislation.

Acquisition of Mortgages to Facilitate Workouts: The Secretary is to coordinate with the FDIC, the Fed, Federal Housing Financing Agency (the Fannie/Freddie conservator), HUD, and other government entities that hold troubled assets “to identify opportunities for the acquisition of classes of troubled assets that will improve the ability of the Secretary to improve the loan modification and restructuring process and, where permissible, to permit bona fide tenants who are current on their rent to remain in their homes under the terms of the lease.” (§ 109(b))

Fiduciary Duty of Mortgage Servicers: “Except as established in any contract, a servicer of pooled residential mortgages owes any duty to determine whether the net present value of the payments on the loan, as modified, is likely to be greater than the anticipated net recovery that would result from foreclosure to all investors or holders of beneficial interests in such investment, but not to any individual or groups of investors or beneficial interest holders, and shall be deemed to act in the best interests of all such investors or holders of beneficial interest holder if the servicer agrees to or implements a modification or workout plan when the services takes reasonable loss mitigation actions, including partial payments.” (§ 119(b)(2))

Both provisions relate to the fact that workouts can be made more complicated when mortgages are securitized rather than being held by lenders. Different classes of investors may have conflicting interests, which can complicate the servicer’s decision to attempt a workout rather than foreclosing. The authority to acquire specified classes of assets and the clarification that servicers owe fiduciary duties to “all investors” and not “groups of investors” seem intended to address this problem.

Secretary is to “consent, where appropriate and considering net present value to the taxpayers, to reasonable requests for loss mitigation measures” such as term extensions and principal writedowns. (§ 109(c))

The “considering net present value to the taxpayers” and “loss mitigation” language emphasizes that only win-win workouts, not relief that takes from lenders or investors to give to borrowers, are contemplated.

Assistance to Homeowners: Section 109, discussed above, addresses interests in real estate that the Secretary acquires under the Act. Section 110 imposes similar requirements on federal agencies that already manage residential property, including the Federal Housing Finance Agency (the conservator of Fannie Mae and Freddie Mac); the FDIC, with respect to mortgage

loans and MBS held by bridge depository institutions; the Fed, with respect to mortgages or MBS held by any Federal Reserve bank. (§ 110(a)).

Like the Secretary, these managers are required to “implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages ... to take advantage of the HOPE for Homeowners Program ... or other available programs to minimize foreclosures.” (§ 110(b)(1)).

Modifications may include reductions in interest rates or principal, and “other similar modifications” (§ 110(b)(2)), and modifications must ensure continuation of rental subsidies and take into account the need for operating funds to maintain decent and safe conditions on the property.” (§ 110(b)(3)). Where federal managers don’t own loans but do own securities secured by loan pools, managers are to “encourage” and “assist in” implementation of modifications by private servicers. (§ 110(c)).

Federal managers are to report to Congress within 60 days of enactment and every 30 days thereafter on “the number and types of loan modifications made and the number of actual foreclosures occurring during the reporting period.” (§ 110(b)(5)).

7. General Regulatory Reform

The Act provides for parallel reports from Treasury and the newly created Congressional Oversight Panel on overall regulatory reform, as well as specific reports from the GAO on leverage in the financial system and from the SEC on mark-to-market accounting. The mark-to-market report, accompanied by a provision “authorizing” the SEC to suspend mark-to-market accounting (which it has the power to do already), seems intended to nudge the agency to relax mark-to-market rules even more than it already has.

Treasury Report on Financial Markets and Regulatory System: Secretary shall “review the current state of the financial markets and the regulatory system and submit a written report to the appropriate committees of Congress not later than April 30, 2009” with special focus on the OTC swaps market and GSEs, including financial market participants that are “outside the regulatory system” should “become subject to the regulatory system.” (§ 105(c)(2))

COP Report on Regulatory Reform: The Congressional Oversight Panel, described below, is to “submit a special report on regulatory reform not later than January 30, 2009,” addressing the current state of the regulatory system and containing recommendations for improvement, including “recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system, the rationale underlying such recommendations, and whether there are any gaps in existing consumer protections.” (§ 122(b)(2)).

Presumably Congress wants a report different from the one that the Secretary submitted in March 2008 and on which action was not taken. The thrust here clearly is toward increasing

regulation. The reference to “participants ... that are currently outside the regulatory system” is unclear, as there are few participants in the U.S. financial markets – even hedge funds – that are completely unregulated.

GAO Leverage Report: GAO is to “undertake a study to determine the extent to which leverage and sudden deleveraging of financial institutions was a factor behind the current crisis” (§ 117(a)). Deadline is June 1, 2009 (§ 117(c)). Study is to address the roles and responsibilities of the Fed, SEC, Secretary, and other federal banking agencies “with respect to monitoring leverage and acting to curtail excessive leveraging,” including “an analysis of the authority of the [Fed] to regulate leverage, including by setting margin requirements, and what process the Board used to decide whether or not to use that authority” and “an analysis of any usage of the margin authority by the [Fed]” (§ 117(b)(2)(3)).

There is apparently an underlying concern about a Fed failure to clamp down on excessive leverage, but not clear that excessive leverage per se at Fed-regulated entities (as opposed to SEC-regulated investment banks or by non-bank-unregulated entities such as AIG) lies at the heart of the crisis.

SEC Mark-to-Market Accounting Report: The SEC is “authorized” to “suspend” FAS 157 (“fair value” or “mark-to-market” accounting) “with respect to any class or category of transaction if the Commission determines that is necessary or appropriate in the public interest and is consistent with the protection of investors.” (§ 132)

The SEC also is required to conduct a “study on mark-to-market accounting standards” within 90 days, including the effects of mark-to-market on financial institution balance sheets; the impacts of such accounting on bank failures in 2008 and the quality of financial information available to investors; the process used by the FASB in developing accounting standards; the advisability and feasibility of modifications to such standards; and “alternative” accounting standards to those provided in FAS 157 (§ 133).

The thrust of these provisions seems clear. Congress is suggesting the elimination or curtailment of mark-to-market accounting. The SEC already has authority to set accounting standards, so “authorizing” it to suspend mark-to-market is technically meaningless. Notably, the agency already has taken action to reduce the effects of mark-to-market accounting. On September 30, the agency announced “clarifications” of its fair-value accounting rules that provided that “distressed or forced liquidation” sales are not probative of fair value, that management may use internal assumptions rather than market quotes when an active market in a security does not exist, and that executed transactions on an “inactive” market “would likely not be determinative” of fair value.

8. Oversight

Although the Act apparently contains nothing that restricts the Secretary's ability to exercise authority prospectively, it does contain extensive oversight provisions and reporting requirements, as well as provision for APA-style judicial review. This is in sharp to the Secretary's initial proposal, which would have made the Secretary's decisions under the Act completely unreviewable, although the sharp limits on injunctive relief may undermine the effectiveness of judicial review. Several new oversight entities are created: a Federal Stability Oversight Board of executive branch officials, with which the Secretary is to consult; a Congressional Oversight Panel appointed by Congressional leaders, which is charged with reporting to Congress; a Special Inspector General, with responsibility for quarterly reports and annual audits. In addition, the Secretary and GAO are to provide ongoing reports to Congress on the program and the Secretary is to post details of each transaction within two days of entering into it. Costs of the program are to be included separately in the President's budget, and OMB and the CBO are to report semiannually to Congress on costs and related issues.

Judicial Review: Secretary's actions under the Act are subject to normal APA review, including that Secretary's "final" actions may "be held unlawful and set aside if found to be arbitrary, capricious, an abuse of discretion, or contrary to law." (§ 119(a)(1)).

This is billed as a major change from the initial draft, which provided for no judicial review of the Secretary's action.

There are sharp limits on injunctive relief, however. Exercises of the power to purchase, manage, and sell assets, and to mitigate foreclosure cannot be enjoined "other than to remedy a violation of the Constitution." (§ 119(a)(2)). Any injunction or equitable relief is automatically stayed, with the stay automatically lifted unless the Secretary seeks a stay from a higher court within 3 days. (§ 119(a)(4)). Judicial consideration of any request for injunction is to be expedited. (§ 119(a)(2)).

It's not altogether clear that the higher court has authority to lift the stay pending final determination. More fundamentally, the limitation on injunctive relief makes it most unclear whether there is an effective remedy in the unlikely event that a court determines that purchases were arbitrary or capricious. Even more fundamentally, commentators have pointed out that all administrative-law review is fundamentally equitable in nature. The automatic stay could apply to any judicial determination that the Secretary's actions are inappropriate. Finally, Congress addresses previous unusual executive actions that arguably were taken without sufficient oversight: The Fed must report on its interventions with Bear Stearns and AIG. The Treasury is forbidden from using the Exchange Stabilization Funds for additional guarantee programs for mutual funds, although the existing guarantee is undisturbed.

Asset sellers cannot sue the Secretary except to set aside final actions on administrative-law grounds or on grounds expressly provided in a written contract. (§ 119(a)(4)).

Financial Stability Oversight Board: Establishes a Financial Stability Oversight Board, consisting of the Treasury and HUD Secretaries, the Fed and SEC Chairs, and the Director of the Federal Housing Finance Agency (§ 104(b)), which is to “review[] the exercise of authority” by the Secretary (§ 104(a)(1) and “ensure that the policies implemented by the Secretary are in accordance with the purposes of the Act; in the economic interests of the United States; and consistent with protecting taxpayers.” (§104(e))

The Board’s power to do this is limited; it is to “report[] any suspected fraud, misrepresentation, or malfeasance” to a Special Inspector General (§ 104(a)(3)) and report quarterly to Congress (§ 104(g)).

Given its limited powers and its makeup, it seems unlikely that the Board will provide meaningful oversight. Although consultation may be useful, it seems likely that the Secretary would consult with the Board members anyway.

Congressional Oversight Panel: Creates an “establishment in the legislative branch” (§ 122(a)) to “review the current state of the financial markets and the regulatory system” (§122(b)). It is a five-member panel with one member appointed by the leader of each party in each house of Congress, and one member appointed by the Speaker of the House after consultation with the minority leaders of the House and Senate. (§ 122(c)(1))

Panel is to report monthly (§ 122(b)(1)(B)) to Congress on the Secretary’s use of authority, the impact of purchases on the financial markets and institutions, the extent to which information made available on transactions has contributed to market transparency, the effectiveness of foreclosure efforts, and the effectiveness of the program from the standpoint of minimizing long-term costs to the taxpayers and maximizing the benefits for taxpayers. (§ 122(b)(1)(A))

COP has the power to hire staff and contract for experts and consultants; funding is open-ended and paid for out of the House and Senate accounts. (§ 122(d),(g)). The COP is empowered to hold hearings, take evidence, and administer oaths, and can “secure directly from any department or agency of the United States information necessary” for it to carry out its duties. “Upon request of the Chairperson of the Oversight Panel, the head of that department or agency shall furnish the information to the Oversight Panel.” (§ 122(e)(3))

Not clear exactly what this scope of investigative power entails. There is no explicit grant of subpoena power.

Special Inspector General: Appointed by the President with the advice and consent of the Senate (§ 121(b)(1)); to be appointed “as soon as practicable after” establishment of a purchase or insurance program (§ 121(b)(3)). Duties are “to conduct, supervise, and coordinate audits and investigations” of the purchase and insurance programs. (§ 121(c)). SIG is permitted to contract for “audits, studies, analyses, and other services with public agencies and with private persons” (§ 121(d)(3)) and is funded up to \$50 million. (§ 121(g))

Quarterly reports are to be issued on the SIG's activities over the preceding 120 days, including (§ 121(f)): a "description of the categories of troubled assets purchased;" a "listing of the troubled assets purchased in each category;" "an explanation of the reasons the Secretary deemed it necessary each such troubled asset;" "a listing of each financial institution that such troubled assets were purchased from;" "a listing of and detailed biographical information on each person or entity hired to manage such troubled assets;" "a current estimate of the total amount of troubled assets purchased... the amount of troubled assets on the books of the Treasury, the amount of troubled assets sold, and the profit and loss incurred on each sale or disposition of each such troubled asset." (§ 121(c)(1)). Also: "a detailed statement of all purchases, obligations, expenditures, and revenues associated" with the purchase and insurance programs. (§ 121(f)).

The creation of a Special Inspector General appears to be a common protection adopted when the government is going to spend a lot of money for a broad set of interrelated purposes quickly. Special Inspectors General have been created in recent years for the Iraq and post-Katrina Gulf Coast reconstruction efforts.

Transparency of Transactions: Secretary to post "a description, amounts, and pricing of assets acquired under this Act, within 2 business days of purchase, trade, or other disposition." (§ 114(a)).

For institutions from which he buys securities, Secretary is to "determine whether the public disclosure required for such financial institutions with respect to off-balance sheet transactions, derivatives instruments, contingent liabilities, and similar sources of potential exposure is adequate to provide the public sufficient information as to the true financial position of the institutions" and to "make recommendations for additional disclosure requirements to the relevant regulators" if inadequate. (§ 114(b))

It's noteworthy that national banks, which are likely to be important sellers in the program, are already regulated by the OCC, which is part of Treasury.

Treasury Reports to Congress: The Secretary is to report to Congress monthly (or within two months for first report) on actions taken, expenditures, and detailed financial statements; contents of reports are prescribed in greater detail for purchases than for sales. (§ 105(a)). Secretary is also required to report within 7 days of each \$50 billion asset purchase threshold, matters including transaction details, "a justification for the price paid," "description of the impact of the exercise" of authority on the financial system, "description of challenges that remain in the financial system," and "estimate of additional actions ... that may be necessary." (§ 105(b))

The Treasury is required to supply "all information used by the Secretary in connection with activities authorized under this Act" to congressional support agencies "to the extent otherwise consistent with law." (§ 201)

This reflects the generally greater focus on purchases than on sales. Many reports are required but there is no mechanism for approvals of decisions. Congressional support agencies include GAO, Congressional Research Service, Congressional Budget Office.

GAO Oversight: Subjects of oversight are: TARP performance, financial condition and internal controls, characteristics of transactions entered into and of dispositions, efficiency in use of funds, compliance with law, efforts to address conflicts of interest, and efficacy of contracting procedures. (§ 116(a)). GAO will report every 60 days to Congress and the Special Inspector General (§ 116(a)(3)) and audit TARP annually (§ 116(b)(1)). TARP is to take action to correct deficiencies or certify to the appropriate committees of Congress that no action is necessary. (§ 116(b)(3)). GAO staff will be installed at Treasury to do oversight (§ 116(a)(2)).

OMB and CBO Budget Reports: OMB is to report within 60 days of the first exercise of authority under the Act, and semiannually thereafter, to the President and Congress (§ 202(a)), on the cost of the assets and guarantees (determined according to § 123); the information used to derive the estimate, and a “detailed analysis of how the estimate has changed from the previous report.” (§202(a)(3)). OMB is also required to explain the differences between its estimates and prior CBO estimates. (§ 202(a)).

Within 45 days of receipt by Congress of each report from OMB, the CBO is to report to Congress its assessment of the OMB report, including the cost of the assets and guarantees, the information and valuation used to calculate the cost, and the impact on the deficit and the national debt. (§202(b)).

Analysis in President’s Budget: President’s budget must contain an analysis of fiscal effects of the program, including an estimate of current asset values, as well as estimates of the value of the deficit and national debt, calculated both on the estimated-NPV basis of § 123 and on a cash basis, and a statement of the portion of the deficit which can be attributed to actions taken under the Act. (§ 203(a)). OMB to consult periodically, but at least annually, with Congressional budget committees and the CBO. (§ 203(b)).

Oversight of Emergency Fed Loans: Fed is required to provide, within 7 days of its exercise of emergency loan authority under 12 U.S.C. § 343, a report that includes “the justification for exercising the authority,” “the specific terms” of the Fed’s actions, and “any expected costs to the taxpayers” (§ 129(a)). Updates are required every 60 days, and must detail the status of the loan, the value of collateral held by the Fed, and the projected cost to the taxpayers of the loan. (§ 129(b))

The Fed may require that these reports be kept confidential. (§ 129(c)).

This is the provision on which the Fed has relied for its unusual actions with respect to Bear Stearns and AIG. Congress is demanding a report on these actions, as the provision is made

effective as of March 1, 2008 (just before the Bear Stearns action). The Bear Stearns and AIG reports are due within 30 days of enactment.

Reimbursement of Exchange Stabilization Fund: The Secretary is required to reimburse the Exchange Stabilization Fund for any funds that are used for the Treasury Money Market Funds Guarantee Program and is to use funds appropriated under the Act, and is prohibited from using the ESF for any future money-market guaranty programs. (§ 131)

The legal authority for Treasury's use of the ESF to guarantee money-market accounts is unclear; according to Treasury's Website, the purpose of the fund is to buy and sell foreign currencies, hold U.S. foreign exchange, and provide financing to foreign governments – all purposes that seem far afield from guaranteeing U.S. money-market investments. One might interpret the Congress's decision to prohibit new uses of the ESF to guarantee money-market investments while leaving the existing program in place as an example of the limits of after-the-fact Congressional action, and thus of the effectiveness of oversight provisions, in the present circumstances.

9. Additional Provisions

Interim Appointment of Assistant Secretary: The Assistant Secretary in charge of the TARP program may be appointed by the Secretary on an interim basis without Senate confirmation. (§ 101(a)(3)).

The Secretary has reportedly appointed Neel Kashkari, currently the Treasury's assistant secretary for international economics, to fill this position.

Deductibility of Losses on Fannie/Freddie Preferred Stock: Banks, thrifts, and bank or thrift holding companies shall treat gains and losses on sales of Fannie Mae and Freddie Mac preferred stock as ordinary income or loss as long as the stock was held on September 6, 2008 or sold between January 1, 2008 and September 6, 2008. (§ 301(a)-(c)). The Secretary may extend this treatment to preferred stock acquired and sold after September 6, 2008, but “the basis of which in the hands of the applicable financial institution at the time of the sale or exchange is the same as the basis in the hands of the person which held such stock on such date.” (§ 301(d)).

The GSEs' many classes of preferred stock fell dramatically on September 6, when the Treasury effectively seized the entities. This preferred stock was widely held, including by many smaller banks. This provision appears to be intended to mitigate the losses by allowing them favorable tax treatment as ordinary income rather than capital gains.

HOPE for Homeowners Amendments: The Act provides for loosening of the standards for assistance under the HOPE for Homeowners Act. Such assistance became available October 1, 2008. The HOPE for Homeowners Act is intended to encourage voluntary refinancing for

homeowners who cannot afford their mortgages by providing federal guarantees for new 30-year fixed mortgages under certain conditions.

There are three areas in the Act that loosens requirements. First, the test for lack of capacity to pay the existing mortgage has been relaxed. It required that the homeowner have a mortgage debt to income ratio of at least 31 percent. The test is now satisfied if the 31 percent test will be met in the future as a result of a mortgage reset. (§ 124; 12 U.S.C. § 1715z-23(e)(1)(B)). Second, the limit on the amount of the refinanced mortgage, formerly 90 percent of the appraised value of the property, has been removed. (§ 124; 12 U.S.C. § 1715z-23(e)(2)(B)). Third, the program originally required that the subordinate liens be extinguished in the event of refinancing, and provision be made for holders of subordinate mortgages to participate in future appreciation of the property. The Act authorizes the Secretary to make payments to the subordinate lienholders in lieu of this future participation in property appreciation. (§ 124; 12 U.S.C. § 1715z-23(e)(4)(A)).

Budget Cost: The “cost” for federal budget purposes of the asset purchases will be determined under the normal procedure for budgeting the costs of federal credit subsidies, under the Federal Credit Reform Act of 1990 (§ 123(a)). This involves comparing the NPV of estimated government payments under the program with the NPV of estimated receipts. (2 U.S.C. § 661a(5)(A)). Of course this is a highly subjective exercise, with key variables being estimated default and prepayment risks. One noteworthy amendment to the usual method of cost calculation is that cash flows are normally discounted at the Treasury (risk-free) rate, (2 U.S.C. § 661a(5)(E)) while the Act provides that the normal discount rate is to be adjusted “for market risk.” (§ 123(b)). That adjustment presumably will raise the discount rate, raising the importance of the initial cost of the purchase relative to the estimated future cash flows.

This apparently governs how the cost of the program will show up in the budget. Under the Federal Credit Reform Act of 1990, budget treatment for federal credit subsidy programs is based on expected subsidy cost rather than cash flows. Congress must appropriate funds equal to the cost calculated under FCRA mechanism, but that is not an issue under the Act because funds are “deemed appropriated when spent.” (§ 118)

Interest on Fed Reserves: In 2006, legislation authorized the Fed to pay interest “not to exceed the general level of short-term interest rates” on reserves maintained at the Fed. (12 U.S.C. § 461(b)(12)). The effective date of this provision is moved up from October 1, 2011 to October 1, 2008 (§128).

As of October 6, 2008, the Fed reportedly had started to pay interest on reserves under this provision.

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