Progress and Update on Financial Stability Plan

March 23, 2009

UNITED STATES DEPARTMENT OF THE TREASURY

Four Fundamental Challenges, Four Solutions

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Financial Stability Plan Update

February 10th	**Introduction of Financial Stability Plan**
February 18th	**Rollout of Housing Plan** • Refinancing for 4 to 5 Million Homeowners • Modification Program for 3 to 4 Million Homeowners • Expanded Support for Freddie Mac and Fannie Mae
February 23rd	**Interagency Statement Reaffirming Commitment to Stabilizing Large Institutions**
February 25th	**Rollout of Capital Assistance Program** • Details of "Stress Test" • Capital Assistance Program White Paper and Term Sheet
March 3rd	**Rollout of Consumer and Business Lending Initiative / TALF** • TALF White Paper • Expanded Asset Classes: Rental, Commercial and Government Vehicle Fleet Leases, Small Ticket Equipment, Heavy Equipment and Agricultural Equipment Loans and Leases
March 4th	**Detailed Guidelines for FSP Housing Plan**
March 16th	**Plan to Unlock Small Business Markets** • $15 Billion in Purchases of Securities • Expanded Small Business Reporting Requirements for FSP Participants
March 19th	**First Subscriptions of TALF and Expansion to Mortgage Servicers and Auto Dealer Floorplan** **Announcement of Auto Supplier Support Program**

Four Fundamental Challenges

There are four fundamental problems facing the financial system. These are prolonging the recession instead of moving us towards recovery:

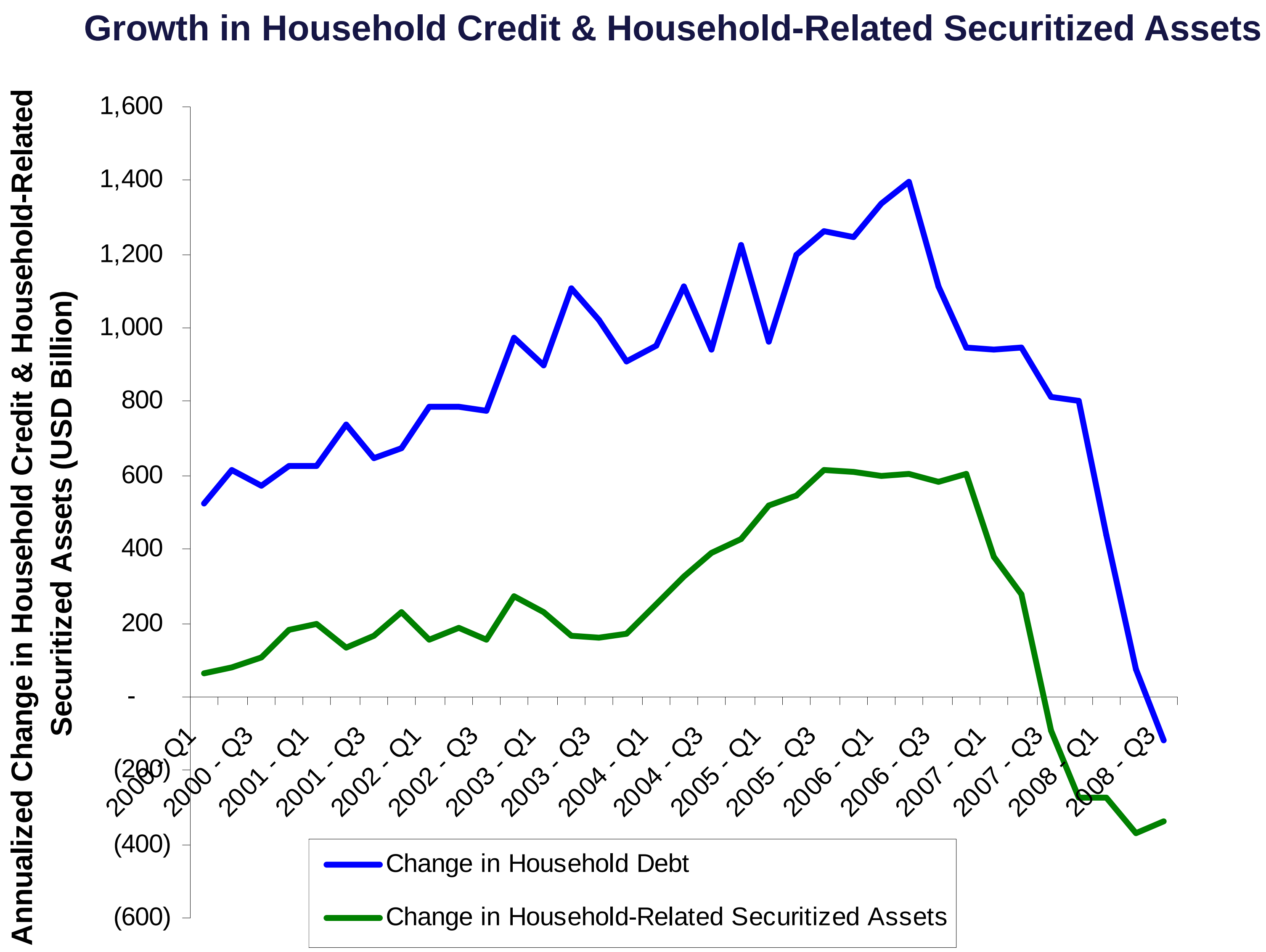
1) ***Falling Home Prices*:** The decline in home prices is hurting the balance sheets of tens of millions of families as well as most of the financial sector

2) ***Frozen Credit Markets:*** A freezing-up of primary credit markets has made it very difficult or too expensive for many businesses, both small and large, to borrow the money they need to grow, and for many households to get loans to buy new cars and homes and to pay for their children's education

3) ***Strengthening Bank Capital:*** Major financial institutions – which do the majority of lending in our nation – are hesitant to lend because they fear they lack the capital to survive a more severe recession

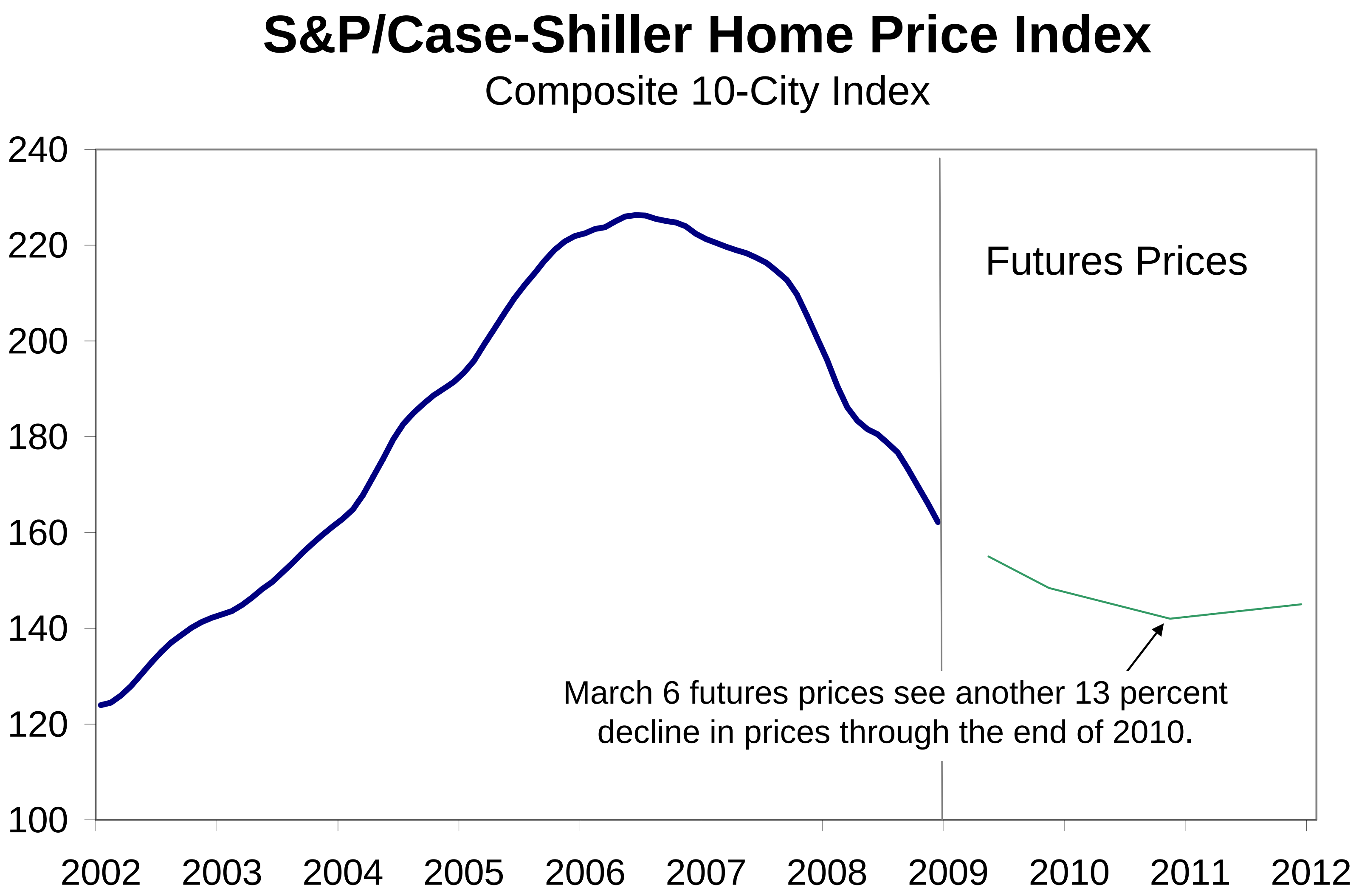
4) ***Troubled Legacy Assets:*** The existence of troubled legacy assets – often called "toxic assets" – is straining the capital of our financial institutions and limiting their ability to lend

Frozen Securitization Markets Have Reduced Consumer Credit



U.S. Treasury

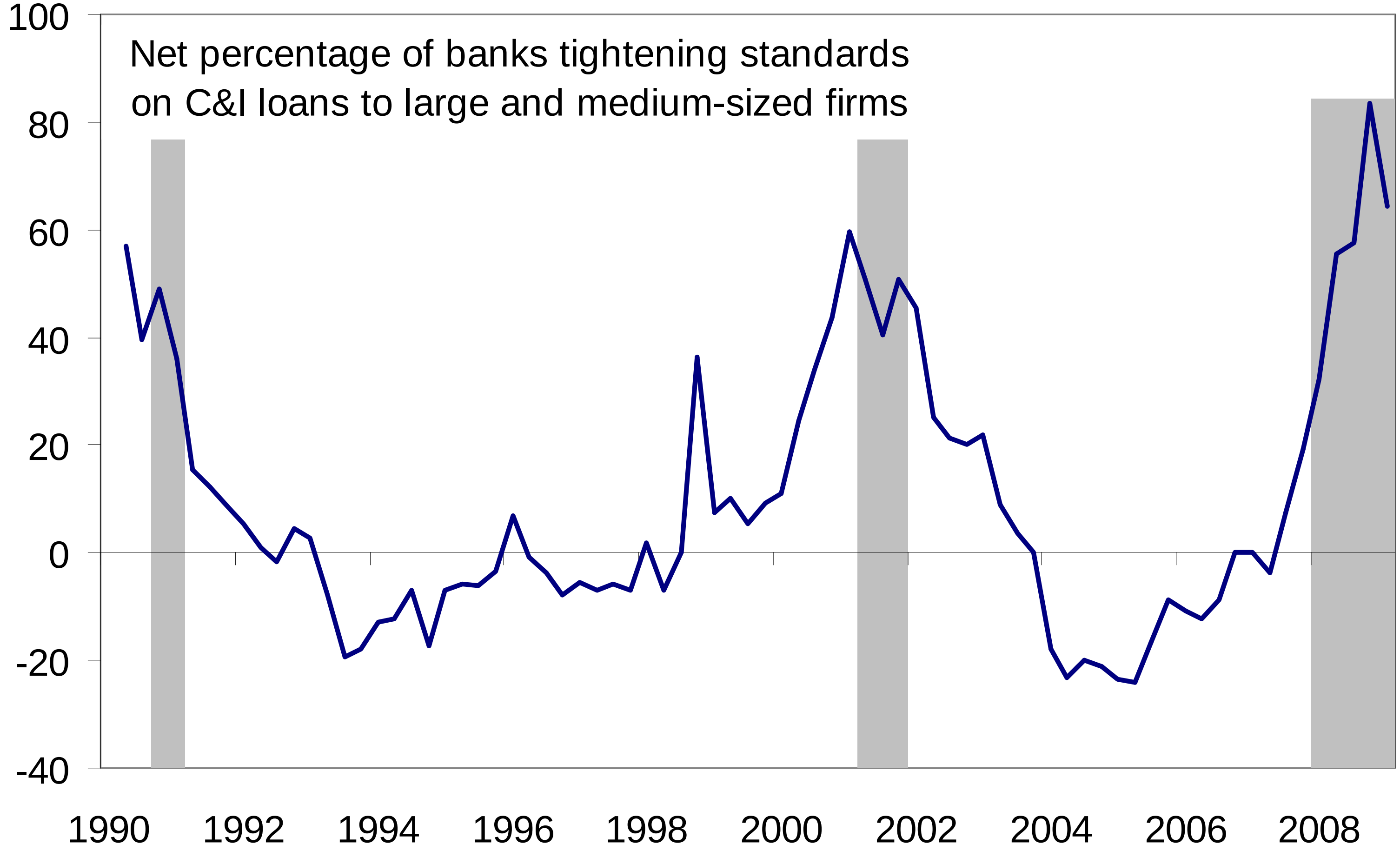
Home Prices Have Fallen Dramatically



U.S. Treasury

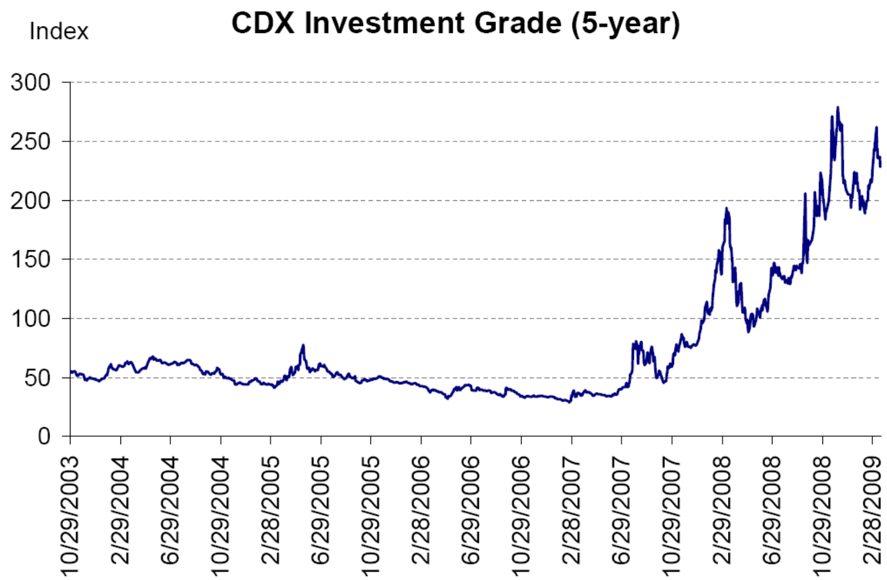
Banks Have Tightened Lending Standards

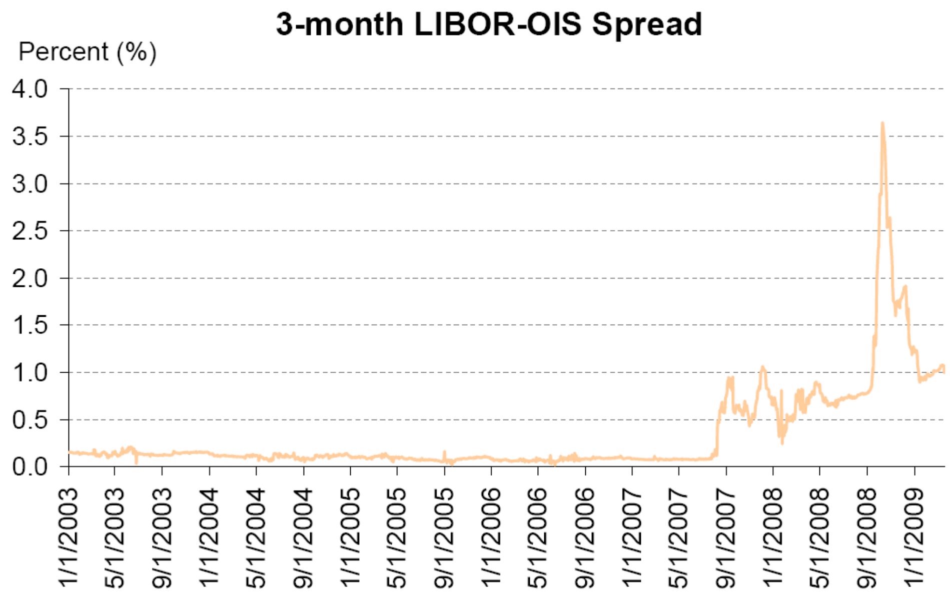
Senior Loan Officer Survey



U.S. Treasury

Markets Remain Stressed





CDX Investment Grade

- The CDX index represents the cost of insuring against the risk of default for a group of investment grade companies

- The higher the index, the more expensive the insurance, indicating that investors are increasingly worried about the financial health of companies

LIBOR-OIS Spread

- The spread is the difference between the LIBOR rate and the overnight index swap (OIS), and is a measure of stress in the credit markets.

- The heightened spread suggests that banks are unwilling to lend to each other. Although the spread has declined since last Fall, it remains very high relative to normal standards.

Challenge #1: Falling Home Prices

Core Problem

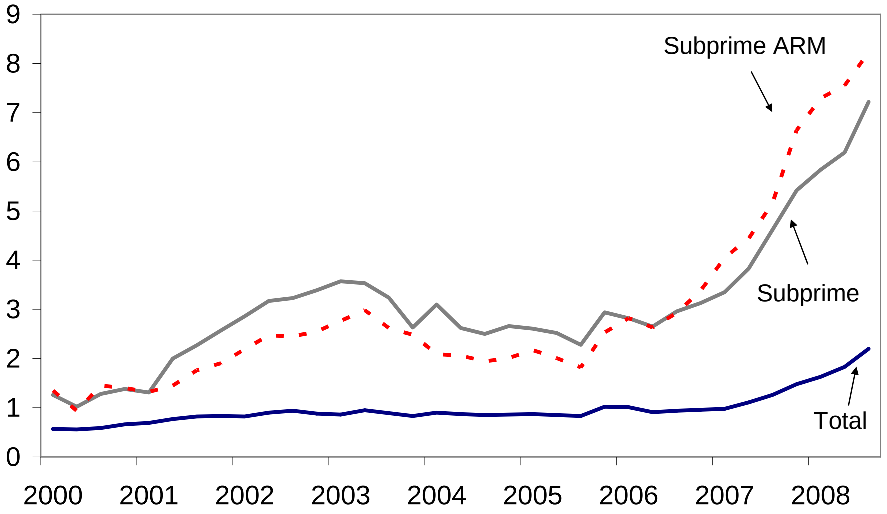
The collapse in home prices served as the catalyst for the current financial crisis, harming both household balance sheets as well as much of the financial sector

- Millions of homeowners have seen their mortgage payments ***rise to as much as 40 or even 50 percent of their incomes, making it more difficult for them to stay in their homes.*** This creates an intensifying spiral, as lenders foreclose, home prices fall still lower, household savings fall, and families become unable to refinance

- Millions of homeowners ***cannot take advantage of low mortgage rates and refinance*** because – through no fault of their own – their homes have fallen in value

Seriously Delinquent Residential Mortgage Loans

Quarterly, percent



Solution #1: FSP Housing Plan

Refinancing Program	• Provide the opportunity for 4 to 5 million homeowners to refinance – reducing their monthly payments
Loan Modification Program	• Create a $75 billion modification program to allow 3 to 4 million families to stay in their homes
Support Low Mortgage Rates through GSEs	• Support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac

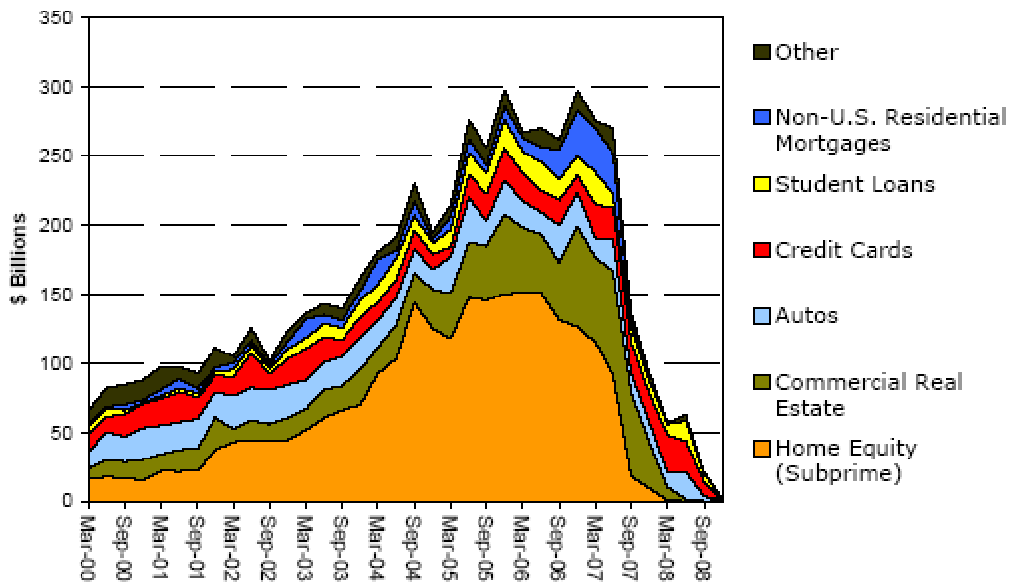
Challenge #2: Frozen Credit Markets

Core Problem

A freezing-up of primary credit markets has made it very difficult or too expensive for many businesses, both small and large, to borrow the money needed to grow, and for many households to get loans to buy new cars and homes and to pay for their children's education

- Market for asset-backed securities, which **until recently supported over 40% of all lending to consumers and businesses**, is frozen
  - Issuance of consumer asset-backed securities – backed by credit cards, auto and student loans – has remained near zero since October
  - Interest rate spreads on AAA-rated consumer ABS are well outside historical norms

New Issuance of Asset-Backed Securities in Previous Three Months



Solution #2: Consumer and Business Lending Initiative

Unfreeze Credit Markets With Expanded TALF

- ***Expanded to $1 Trillion:*** TALF – intended to provide credit to investors purchasing new and old securities – expanded up to $1 trillion in collaboration with Federal Reserve
- ***New Asset Classes Added:*** Asset classes expanded from credit cards, auto loans, student loans and SBA loans to rental, commercial and government vehicle fleet leases small ticket equipment and heavy equipment leases, agricultural equipment loans and leases and commercial mortgage backed and older securities

Unlock Small Business Lending

- ***Up to $15 Billion in Purchases:*** Plans for direct purchases of up to $15 billion in securities backed by Small Business Administration-guaranteed loans
- ***Higher Guarantees and Eliminated Fees:*** Implementation of 90% loan guarantees, temporary fee elimination for SBA loans
- ***Small Business Reporting Requirements:*** New reporting requirements for 21 largest FSP recipients on small business lending

Challenge #3: Strengthening Bank Capital

- **The Need for Diagnosis**
  - A doctor cannot treat a patient without first diagnosing the illness. Policymakers cannot fix the banking system without investigating the state of balance sheets and asset quality of our major banks
- **Bank capital is vital to economic activity**
  - When banks do not have enough capital, they cannot lend
  - Individual banks may try to boost capital ratios by shrinking their balance sheets (i.e. deleveraging) as opposed to raising new capital. However, these actions impose costs on the broad economy
  - By ensuring that institutions have enough capital to lend during a more adverse economic scenario, *banks should regain the confidence to lend today,* aiding our broader recovery efforts
- **Even if legacy assets are successfully removed from bank balance sheets, bank capital still must be strengthened**
  - A comprehensive approach must jointly tackle the problems of legacy assets and capital adequacy

Solution #3: Capital Assistance Program – Update and Progress

February 10th	**Announcement of Financial Stability Plan** • Outline of Comprehensive Stress Test • Introduction of Capital Assistance Program • New Conditions for Transparency and Monitoring of Capital Recipients
February 25th	**Launch of Capital Assistance Program "Stress Test'** • Publication of the "Stress Test" Economic Assumptions • Capital Assistance Program White Paper • Term Sheet Released
By the End of April	**Capital Assessment of Banks Concludes**

Solution #3: Measuring Capital Needs – Elements

- **Requiring Sufficient Capital for Worse-Than-Expected Economic Conditions**
  - Capital buffers will be set so banks have sufficient resources to play their vital role in credit formation even in a more adverse economic environment

Economic Scenarios: Baseline and More Adverse Scenarios

	2009	2010
Real GDP (% percent change year over year)		
Baseline	-2.0	2.1
More Adverse	-3.3	0.5
Civilian unemployment rate (% annual average)		
Baseline	8.4	8.8
More Adverse	8.9	10.3
House prices (Case-Shiller 10-City Composite)		
Baseline	-14	-4
More Adverse	-22	-7

- **Assessments Concluded by End of April**
  - Supervisors will inform banks of their additional buffers at end of April
  - If an additional capital buffer is needed, banks will have 6 months to raise this from private investors. However, Treasury is making government capital available immediately through the Capital Assistance Program as a bridge to private capital.
  - New government capital will be in the form of preferred stock that can be converted into common stock over time by the bank.

Challenge #4: Troubled Legacy Assets

- **Vicious market cycle has pushed prices below fundamentals**
  - Bursting of housing bubble caused initial losses for financial institutions on residential mortgages and related securities
  - Initial losses resulted in the need to reduce risk and leverage. As a result, institutions were forced to sell, causing further price declines. This fueled further deleveraging, creating a vicious cycle
- **Troubled assets are clogging balance sheets of financial firms**
  - Depressed prices for legacy assets are straining the capital of financial institutions and have reduced their ability to lend
  - ***Legacy Loans:*** The overhang of troubled legacy loans stuck on bank balance sheets has made it difficult for banks to access private markets for new capital and limited their ability to lend.
  - ***Legacy Securities:*** Secondary markets have become highly illiquid, and are trading at prices below where they would be in normally functioning markets. These securities are held by banks as well as insurance companies, pension funds, mutual funds, and funds held in individual retirement accounts.

Solution #4: Public-Private Investment Program

- **Three Main Principles of FSP Strategy for Legacy Assets**
  - ***Maximizing the Impact of Each Taxpayer Dollar:*** By using government financing in partnership with the FDIC and Federal Reserve and co-investment with private sector investors, we will create substantial purchasing power, making the most of taxpayer resources.
  - ***Shared Risk and Profits With Private Sector Participants:*** The Public-Private Investment Program ensures that private sector participants invest alongside the taxpayer, with the private sector investors standing to lose their entire investment in a downside scenario and the taxpayer sharing in profitable returns.
  - ***Private Sector Price Discovery:*** To reduce the likelihood that the government will overpay for these assets, private sector investors competing with one another will establish the price of the loans and securities purchased under the program.

Solution #4: Public-Private Investment Program

Public-Private Investment Program

- **$75 to 100 billion of TARP/FSP capital**
- **With financing from the FDIC and Federal Reserve, leverage $500 billion with potential to expand to $1 trillion of purchasing power**

Legacy Loans Program

Capital
Public-Private Investment Funds

- Combines USG and private capital

Financing
Funds Will Raise FDIC Guaranteed Debt

- FDIC will guarantee debt
- Leverage up to 6:1

Legacy Securities Program

Capital
Public-Private Investment Funds

- Combines private capital with USG capital and potential USG leverage

Financing
Leverage from Federal Reserve

- Builds on existing TALF framework

Solution #4: Legacy Loans Program

Goal	To allow banks to cleanse legacy assets in order to remove the overhang of uncertainty, ***using federal and private sources to finance purchases of loans on bank books (accrual assets)***
Mechanics	Banks approach FDIC with a pool of legacy loans. FDIC offers leverage and Treasury offers co-investment to groups of investors who bid in an auction for the loans
Private Sector Sets Prices	The auction ***determines prices that the private sector will pay***
Leverage	Leverage will be up to 6 to 1 debt to equity ratio and vary from pool to pool in accordance with underlying risk. Bidders would have access to co-investment from Treasury for up to 50% of the equity required for purchase
Full Use of Resources	The Legacy Loans Program uses the full power of government as ***a joint venture with the FDIC and Treasury***

Solution #4: Example Under Legacy Loans Program

- **Step 1:** If a bank has a pool of residential mortgages with $100 face value that it is seeking to divest, the bank would approach the FDIC.
- **Step 2:** The FDIC would determine, according to the above process, that they would be willing to leverage the pool at a 6-to-1 debt-to-equity ratio.
- **Step 3:** The pool would then be auctioned by the FDIC, with several private fund managers submitting bids. The highest bid from the private sector – in this example, $84 – would be the winner and would form a Public-Private Investment Fund to purchase the pool of mortgages.
- **Step 4:** Of this $84 purchase price, the FDIC would provide guarantees for $72 of financing, leaving $12 of equity.
- **Step 5:** The Treasury would then provide 50% of the equity funding required on a side-by-side basis with the investor. In this example, Treasury would invest approximately $6, with the private investor contributing $6.
- **Step 6:** The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis – using asset managers approved and subject to oversight by the FDIC.

Solution #4: Legacy Securities Program

Mechanism #1: Deploy TALF for Legacy Assets	
Goal	To thaw out frozen secondary markets for pre-existing securities tied to residential real estate, commercial real estate and consumer credit
Mechanics	Through the Consumer and Business Lending Initiative, the TALF will be ***expanded to include older RMBS that were originally rated AAA*** and ***outstanding CMBS and ABS that are currently rated AAA***. "Haircuts" will be larger than for traditional TALF asset classes due to the riskier nature of the assets
Private Price Discovery	As with all uses of TALF, this ***relies on financing to bring in private-sector investors*** to set prices and restart frozen secondary markets
Leverage	FSP dollars leveraged for greater impact by ***using TALF framework with Federal Reserve***

Mechanism #2: Legacy Securities Public-Private Investment Funds	
Goal	To direct additional capital towards the market for legacy assets and to spur competition in those markets
Mechanics	Five or more investment managers with strong track records in targeted asset classes will be able to raise capital with a 1:1 USG match and then co-invest with the USG with equally shared losses and gains. If they meet certain guidelines, PPIFs will be able to subscribe for senior debt from Treasury from 50 to 100 percent of the total equity capital of the fund. It is expected that PPIFs will also borrow from the TALF if the managers so choose.
Private Price Discovery	As Funds managed by private sector investors compete with each other, they should ***support the price for legacy securities, but will prevent the Government from overpaying***
Leverage	Designed to leverage $2 in public capital (equity and debt) for every $1 in private equity

Solution #4: Example Under Legacy Securities Program

- **<u>Step 1</u>**: Treasury will launch the application process for managers interested in the Legacy Securities Program.
- **<u>Step 2:</u>** A fund manager submits a proposal and is pre-qualified to raise private capital to participate in joint investment programs with Treasury.
- **<u>Step 3:</u>** The Government agrees to provide a one-for-one match for every dollar of private capital that the fund manager raises and to provide fund-level leverage for the proposed Public-Private Investment Fund.
- **<u>Step 4:</u>** The fund manager commences the sales process for the investment fund and is able to raise $100 of private capital for the fund. Treasury provides $100 equity co-investment on a side-by-side basis with private capital and will provide a $100 loan to the Public-Private Investment Fund. Treasury will also consider requests from the fund manager for an additional loan of up to $100 to the fund.
- **<u>Step 5:</u>** As a result, the fund manager has $300 (or, in some cases, up to $400) in total capital and commences a purchase program for targeted securities.
- **<u>Step 6:</u>** The fund manager has full discretion in investment decisions, although it will predominately follow a long-term buy-and-hold strategy. The Public-Private Investment Fund, if the fund manager so determines, would also be eligible to take advantage of the expanded TALF program for legacy securities when it is launched.